S. HRG. 100-951

NATURAL GAS BYPASS

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 1998

TO REGULATE INTERSTATE NATURAL GAS PIPELINES PROVIDING TRANSPORTATION SERVICE WHICH BYPASSES LOCAL DISTRIBUTION COMPANIES AND TO ENCOURAGE OPEN ACCESS TRANSPORTATION BY LOCAL DISTRIBUTION COMPANIES AT COST-BASED RATES

S. 2313

TO COORDINATE THE REGULATORY AUTHORITY OF THE FEDERAL ENERGY REGULATORY COMMISSION WITH THAT OF STATE OR LOCAL REGULATORY AGENCIES RELATIVE TO SERVICE WHICH WOULD BYPASS LOCAL UTILITY SERVICE AND TO FACILITATE THE RESOLUTION AT THE STATE OR LOCAL REGULATORY LEVEL OF COMPETITION POLICY ISSUES RELATING TO LOCAL SERVICE

SEPTEMBER 29, 1988

Printed for the use of the
Committee on Energy and Natural Resources

U.S. GOVERNMENT PRINTING OFFICE
93-208 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S311-28

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NATURAL GAS BYPASS

THURSDAY, SEPTEMBER 29, 1988

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room SD-366, Dirksen Senate Office Building, Hon. Wyche Fowler, Jr., presiding.

OPENING STATEMENT OF HON. WYCHE FOWLER, JR., U.S. SENATOR FROM GEORGIA

Senator FOWLER. Good morning, everybody, this is the Committee on Energy and Natural Resources, the Subcommittee on Energy Regulation and Conservation. I am Wyche Fowler from Georgia. I will be conducting the hearing today with some others of my colleagues as they come in.

We are here this morning to explore the issue of bypass in the gas pipeline industry. This, as I am sure everybody in this room knows, is a complex issue with many valid arguments on the various sides. The only certainty seems to be that there are very large dollar amounts at stake.

"Bypass" is a term used to describe what happens when a natural gas user switches from using the facilities of one company to supply gas to using those of another. It can take various forms. For example, a large industrial user of natural gas may wish to stop being supplied natural gas by the local utility and hook up directly to a pipeline. Or the utility may wish to stop being supplied natural gas by one pipeline in favor of another.

Those wishing to bypass their existing supplier generally do so to secure cheaper supplies of gas than the present supplier is willing or able to provide. Those opposing the bypass are generally the utility or pipeline that will be bypassed, and their remaining customers.

The gas industry has been undergoing significant changes in the last 4 years as a result of FERC's actions promoting competition in the industry.

As a result of these policies, producers may now have greater opportunity to market their gas. Pipelines now have a greater choice to sell the gas that they buy from producers, or to transport customer-owned gas. Electric utilities and independent power producers may now contract for their own supplies directly with producers. They may also buy gas from their traditional pipeline suppliers and LDC's. The same may now be true for large industrial customers and cogenerators, including enhanced oil recovery operators.

Clearly, then, the gas business as we knew it for many, many years is in a state of flux. The committee will be interested in hearing today's witnesses as we take our initial look at this issue.

We have a full itinerary of witnesses this morning attempting to not only accommodate those who wish to testify, but also to accommodate the various viewpoints which, as always, is the only purpose of a public hearing, to hear as many viewpoints as possible and to encourage public participation and examination of various issues that we may or may not in some future Congress address either legislatively or administratively.

We are going to do it by panels this morning. May I invite the first panel to come to the witness table.

I have my colleague here, Senator Breaux. Let me take him first in the great tradition of comity. Maybe also excellence. For those of you who do not know him, this is my friend and colleague from Louisiana, Senator John Breaux. Welcome, Senator Breaux, and we will be delighted to have your testimony.

[The texts of S. 1998 and S. 2313 follow:]

II

100TH CONGRESS
1ST SESSION

S. 1998

To regulate interstate natural gas pipelines providing transportation service which bypasses local distribution companies and to encourage open access transportation by local distribution companies at cost-based rates.

IN THE SENATE OF THE UNITED STATES

DECEMBER 22 (legislative day, DECEMBER 15), 1987

Mr. BREAUX introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

---

A BILL

To regulate interstate natural gas pipelines providing transportation service which bypasses local distribution companies and to encourage open access transportation by local distribution companies at cost-based rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Natural Gas Consumers Protection Act".

SEC. 2. FINDINGS AND PURPOSES.

(a) FINDINGS.—The Congress finds that—

(1) certain interstate pipelines are building facilities to interconnect with large industrial natural gas users currently served by local distribution companies thus causing needless duplication of facilities and economic inefficiency;

(2) the Federal Energy Regulatory Commission has promoted such local distribution company bypass by creating unfair marketing opportunities for interstate pipelines at the expense of local distribution companies and small consumers;

(3) unfettered bypass will allow the interstate pipelines to consolidate unfairly their monopoly positions to the detriment of producers, consumers, and distributors of natural gas;

(4) States have an essential role to play in the regulation of retail natural gas rates within their borders;

(5) the Federal Energy Regulatory Commission's bypass policy removes the ability of State commissions to structure fair and equitable rates for gas consumers within their States; and

(6) the Federal Energy Regulatory Commission has failed to devise a Federal policy that respects State concerns and acknowledges the inherent unfairness and

inefficiency of forcing local distribution companies to compete with interstate pipelines.

(b) PURPOSES.—The purposes of this Act are to—

(1) protect residential and small commercial users of natural gas from interstate pipeline market-raiding activities that may benefit a few large natural gas consumers, but which will burden the vast majority of natural gas users with higher rates;

(2) restore the ability of State commissions to structure fair and equitable rates for all gas consumers within their States;

(3) prevent interstate pipelines from consolidating unfairly their monopoly positions to the detriment of producers and consumers of natural gas;

(4) help assure fair competition between interstate pipelines and local distribution companies;

(5) provide for the long-term viability of the natural gas market; and

(6) prohibit the bypass of a local distribution company by an interstate pipeline if the local distribution company is willing to transport natural gas without discrimination at the rate for such service established by the State commission.

SEC. 3. UNECONOMIC BYPASS PROHIBITED.

Any State, municipality, State commission, or local distribution company may petition the Federal Energy Regulatory Commission to prohibit an interstate pipeline from transporting gas, either directly or indirectly, in interstate commerce for any person, which transportation is displacing or bypassing, or will displace or bypass, any or all sales or transportation services provided or offered to such person by a local distribution company. The Commission may grant the petition notwithstanding the fact that a certificate of public convenience and necessity authorizing such transportation has previously been issued by the Commission. The Commission shall grant the petition if it is demonstrated that the local distribution company is—

(1) willing to transport or is transporting gas without discriminating on the basis of the source, ownership, or destination of the gas; and

(2) willing to transport or is transporting gas at the cost of providing that service as determined by its State commission.

SEC. 4. DEFINITIONS.

As used in this Act—

(1) the term "interstate pipeline" means any person engaged in the interstate transportation of natural gas;

(2) the term "local distribution company" means any person, other than any interstate pipeline or any intrastate pipeline (as such term is defined in section 2(16) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301(16)), engaged in the transportation, or local distribution, of natural gas and the sale of natural gas for ultimate consumption; and

(3) the term "State commission" means the regulatory body of the State or municipality having jurisdiction to regulate rates and charges for the sale of natural gas to consumers within the State or municipality.

○

II

100TH CONGRESS
2D SESSION

S. 2313

To coordinate the regulatory authority of the Federal Energy Regulatory Commission with that of State or local regulatory agencies relative to service which would bypass local utility service and to facilitate the resolution at the State or local regulatory level of competition policy issues relating to local service.

IN THE SENATE OF THE UNITED STATES

APRIL 22 (legislative day, APRIL 11), 1988

Mr. CRANSTON introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

---

A BILL

To coordinate the regulatory authority of the Federal Energy Regulatory Commission with that of State or local regulatory agencies relative to service which would bypass local utility service and to facilitate the resolution at the State or local regulatory level of competition policy issues relating to local service.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Natural Gas Transition Act of 1988".

SEC. 2. BYPASS RESTRAINT.

(a) The Federal Energy Regulatory Commission shall not permit service pursuant to the Natural Gas Act or the Natural Gas Policy Act of 1978 where that service would displace any service being provided or which could be provided by a local distribution company if—

(1) the State or local commision with jurisdiction over an affected local distribution company certifies to the Commission that, in its judgment, the service would prejudice the present or future interests of the customers of the affected local distribution company; or

(2) the proposed service is protested by an affected local distribution company and the proponent of the service fails to demonstate, after a hearing on the record, that the affected local distribution company is not willing to provide transportation service on terms and conditions in effect, or accepted or approved by its State or local commission.

(b) In no event shall the Commision permit service that would displace any service being provided or which could be provided by a local distribution company unless and until thirty days after the Commission has published a notice of the proposed service in the Federal Register.

(c) For purposes of this Act, the term "local distribution company" means any entity engaged in the distribution of natural gas for consumption and regulated or operated as a pubic utility by a State or local government or agency thereof.

(d) This Act shall apply to all service not provided before the date of enactment of this Act, regardless of whether the authority to provide such service was granted by the Commission before such date.

○

STATEMENT OF HON. JOHN B. BREAUX, U.S. SENATOR FROM LOUISIANA

Senator **Breaux**. Thank you very much, Mr. Chairman, for having these hearings and agreeing to listen the witnesses that we have today behind me.

As they said when it was a complicated issue was presented to a particularly prominent politician, he said some of my friends are against it, some of my friends are for it, and I am with my friends.

And I would like to be able to think that although there are different positions on the legislation pending, that everybody probably has a common interest, and that common interest is to maximize the utilization of what is the cleanest burning fuel in the United States? Natural gas.

It is somewhat ironic, Mr. Chairman, I think you will agree that we are right now debating millions of dollars of subsidies so that this country can burn dirty coal with very high sulfur content.

It is very ironic and does not make any sense to this Senator because we are really the Saudi Arabia of natural gas, which is by far the cleanest burning fuel and one of the very safest ways of generating energy for this country. There can be no doubt about that.

So, instead of looking for ways to subsidize our Nation's industries so that they can burn dirty coal, we should be looking at ways to try and increase the use of the cleanest burning fuel, natural gas.

And that is why I am here, and that is what my concern is. I am from probably the largest natural gas producing State in the whole country, the State of Louisiana. And whatever we do in Congress, I want to ensure that we do it in the interests of natural gas producers and those who use it both from the selfish standpoint of representing my State, but also from the national interests of having a fuel that is clean and healthy and can meet the energy needs for the future.

So, what are we talking about here? Very simply, we are talking about how people get natural gas to their residences, to their businesses, and to their industries from the producing States that have the product.

The most common way that it has been done generally is for a producer in south Louisiana to sell his gas to an interstate pipeline. They purchase it. They put it in a pipeline, and they send it to a distribution company, say, in the State of Michigan. And that distribution company then has to get that gas to the millions and millions of households and businesses and industrial users, and they do that by constructing feeder pipelines to those end users.

The price they pay for the gas in Louisiana is free market now. Whatever that pipeline is willing to pay and the producer is willing to sell it at is the price that they agree on. When that gas gets to that distribution company and that sale is made, that sale also is a free market sale. But, the price that that distribution company sells to all those residential companies is regulated by the public service commission or the State, comparable type of authority.

And that public service commission assures that the company will get a fair return on their investment. It also protects the consumer.

What is happening that gives me concern, Mr. Chairman, is that FERC, Federal Energy Regulatory Commission, has now started allowing something that previously had not been allowed, the so-called bypass provision. And the bypass provision allows that interstate pipeline to go directly to maybe the very best customer and sell directly to them.

The concern I have is that that sale is not regulated by anyone, not by the public service commission and not by the State under the situation that we have.

And my concern with that from a consumption and utilization standpoint is that if the pipelines are allowed to peel off the very best customers and sell directly to them while gas companies are continuing to sell to the distribution company, that distribution company if he loses his best customer is still going to have to pay for all those little lines that we are talking about.

And if he has to raise his price to those customers, they have an alternative of perhaps switching to an alternate fuel if the price is too high, or they have the alternative of using less and conserving and not meeting their energy needs.

So, my concern with all this, Mr. Chairman, is that we ought to be looking at this, we as the Congress. We shouldn't let the regulators make such a massive policy decision without some guidance from the Congress.

I am not certain what the answer is, but I think that we ought to be involved in deciding that answer. And what my legislation basically says is simple in its nature and it is not a prohibition against this bypass to the direct industrial users. It does not prohibit that at all.

It says quite clearly that any State may petition, any public service commissioner may petition to prohibit an interstate pipeline from going directly to that industrial customer, and the commission shall grant the petition if it is demonstrated that the local distribution is willing to transport and to serve that industrial customer and, secondly, is willing to do it at the cost of providing that service as determined by its State commission.

In other words, if that industrial plant is already getting the service at the price determined by the public service commission, well, then, they would not be able to allow the bypass. If somehow the interstate pipeline could do a better job, well, then, it would be allowed. So, it is not a prohibition.

Mr. Chairman, I think it is something that needs to be looked at, and we need to consider whether we are trying to do what is needed to increase the use of the best burning fuel in this country. As a senator who represents a producing State, I want to make sure that we do not decrease our production of this fuel, decrease the sales of this fuel by allowing something that is a creation of a regulatory commission without any guidance from the Congress.

Mr. Chairman, you will hear a number of witnesses today who have the same goal in common, and that is the utilization of gas and approach it from, perhaps, different approaches. But, we should be involved in determining what the policy should be. Thank you.

Senator **Fowler**. Senator Breaux, thank you very much for your testimony.

For the record, as Senator Breaux stated, he has a bill, S. 1998, which I am sure we will hear discussed in detail this morning by various witnesses. Also, Senator Cranston has a somewhat different approach to the problem in S. 2313 which is pending.

I have statements by Senator Cranston, Senator McClure, Senator Don Nichols of Oklahoma, and Senator Kassebaum, which without objection we will place in the record at this point.

[The prepared statements of Senators Cranston, McClure, Nickles, and Kassebaum follow:]

STATEMENT OF SENATOR ALAN CRANSTON RE NATURAL GAS BYPASS

MR. CHAIRMAN,

I WANT TO THANK YOU FOR CHAIRING THIS HEARING TODAY TO LOOK INTO THE ISSUE OF NATURAL GAS BYPASS AND SPECIFICALLY, TO EXAMINE SENATE BILL S.1998, INTRODUCED BY SENATOR BREAUX AND S.2313, A BILL I INTRODUCED EARLIER THIS YEAR.

THE BYPASS SITUATION ARISES WHEN A LARGE USER OF NATURAL GAS DECIDES TO HOOK UP DIRECTLY TO AN INTERSTATE PIPELINE AND THUS "BYPASS" THE LOCAL UTILITY. ALTHOUGH A RELATIVELY STRAIGHTFORWARD SITUATION ON THE SURFACE, THERE ARE MORE PARTIES INVOLVED IN THE EQUATION THAN JUST THE LOCAL DISTRIBUTION COMPANY (LDC), THE PIPELINE AND THE END USER -- NAMELY, THE REMAINING CUSTOMERS ON THE SYSTEM.

THE EFFECTS OF BYPASS, ALTHOUGH BENEFICIAL TO THE ONE OR SEVERAL END USERS, MAY HAVE JUST THE OPPOSITE CONSEQUENCES FOR THE REMAINING CUSTOMERS OF THE LDC. WHEN A BYPASS OCCURS, COSTS ARE INVARIABLY SHIFTED FROM THE CUSTOMER WHO BYPASSES THE LOCAL DISTRIBUTOR TO RESIDENTIAL, COMMERCIAL AND SMALL INDUSTRIAL CUSTOMERS STILL ON THE SYSTEM -- CUSTOMERS WHO SIMPLY DON'T HAVE THE OPTION TO LEAVE THE SYSTEM. THEREFORE, AN END USER'S NET GAIN MAY TRANSLATE INTO HIGHER RATES FOR EVERYONE ELSE.

AT THE HEART OF THE BYPASS ISSUE IS THE QUESTION OF WHAT ROLE THE FEDERAL AND STATE AGENCIES SHOULD PLAY IN DECIDING THE MERITS OF A PARTICULAR BYPASS.

THE NET EFFECT OF EACH BYPASS CASE, WHETHER BENEFICIAL OR DETRIMENTAL - WILL BE FELT LOCALLY. THE STATE PUBLIC UTILITY COMMISSIONS, WHICH TRADITIONALLY HAVE RESPONSIBILITY FOR LOCAL GAS DISTRIBUTION AND ARE CHARGED WITH THE RESPONSIBILITY TO PROTECT THE INTERESTS OF ALL LDC CUSTOMERS, ARE IN THE BEST POSITION TO GAGE THE EFFECTS OF A PROPOSED BYPASS FOR A MAJORITY OF ALL RATEPAYERS.

MY BILL WOULD NOT PROHIBIT UTILITY BYPASS BUT WOULD ENSURE THAT STATE UTILITY COMMISSIONS PLAY A KEY ROLE IN DETERMINING THE MERITS OF A BYPASS ON A CASE BY CASE BASIS. BASICALLY, IT PROVIDES THAT FERC COULD NOT PERMIT A BYPASS WHERE THE STATE OR LOCAL COMMISSION HAS MADE A FINDING THAT THE BYPASS "WOULD PREJUDICE THE PRESENT OR FUTURE INTERESTS" OF THE OTHER RATEPAYERS. IN ADDITION, BYPASS WOULD NOT BE ALLOWED IF THE LOCAL DISTRIBUTION COMPANY IS WILLING TO PROVIDE TRANSPORTATION SERVICE UNDER TERMS SET BY THE STATE OR LOCAL COMMISSION.

HISTORICALLY, STATE AND LOCAL COMMISSIONS HAVE REGULATED ISSUES INVOLVING NATURAL GAS SERVICE TO END USERS AND I BELIEVE THAT THEY CONTINUE TO BE IN THE BEST POSITION TO DO SO.

AGAIN, MR. CHAIRMAN, I WANT TO COMMEND YOU FOR THE TIMELY NATURE OF THIS HEARING AND I LOOK FORWARD TO AN INFORMATIVE DISCUSSION ON THIS ISSUE.

SENATOR JAMES A. McCLURE
RANKING MINORITY MEMBER
COMMITTEE ON ENERGY AND NATURAL RESOURCES
AT THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION HEARING
ON S. 1998 AND S. 2313
SEPTEMBER 29, 1988

I am pleased that the Subcommittee on Energy Regulation and Conservation is holding this hearing on the issue of local distribution company bypass, and the two bills pending before the Subcommittee, S. 1998 and S. 2313.

LDC bypass has been a matter of concern to the Energy and Natural Resources Committee for some time; it last arose during our 1983 deliberations on S. 1715, a bill which dealt comprehensively with distortions in the natural gas marketplace.

Both of the pending bills propose to address the issue not by prohibiting bypass, but instead by transferring the decision-making power from the Federal Energy Regulatory Commission to state public utility commissions. This appears to reflect the sponsors' belief that the FERC is not properly discharging its statutory authority, and that state commissions would do a better job.

Therefore, if we legislate on this matter, the central question is: Who will do a better job in protecting the overall public interest -- the Federal Energy Regulatory Commission or state utility commissions?

At this time, it is not clear to me who would do a better job. I can certainly understand those who have been critical of recent FERC actions as being insensitive to state and local concerns. One only need look at the reaction of state utility commissions to the three

FERC pending "electricity strategy" notices of proposed rulemaking.

But now that the President has nominated a full slate of FERC Commissioners, I hope, and expect, that a balance will be restored to the Commission's decision-making process once they are confirmed by the Senate -- which I expect will occur very soon.

With respect to today's hearing, I am disappointed that the witness list does not include any state utility commissioners or any members of the Federal Energy Regulatory Commission. Due to their absence, I do not believe that the record the Committee is today creating provides an adequate basis on which the Committee can reach a judgement on this matter. I would expect the Subcommittee to hold at least one more day of hearings in order to receive testimony from state commissioners and members of the FERC. After all, it is state commissioners and FERC members who can best explain how they would weigh and balance the various competing interests, and determine what is in the overall public interest. In this connection, I must also note my disappointment that one of the principal proponents of this legislation, Michigan Consolidated Gas Company, declined to testify at today's hearing.

There are many dimensions to the issue of LDC bypass, and I hope that at today's hearing we can at least begin to explore some of them. I believe that additional hearings will be required in order for the Committee to complete the hearing record and to reach an informed judgement.

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
HEARING ON NATURAL GAS BYPASS LEGISLATION
STATEMENT OF SENATOR DON NICKLES

September 29, 1988

Let me begin, Mr. Chairman, by observing that the bills on which the Subcommittee is receiving testimony today raise complex issues that may not be easily resolved. Moreover, the sweeping changes proposed by these bills, S. 1998 and S. 2313, could have a significant economic impact on the natural gas industry and gas consumers. Accordingly, I am very concerned about the adequacy of the record that will be established today. Several key witnesses are absent, including representatives of Michigan Consolidated Gas, a principal champion of anti-bypass legislation, and FERC Chairman Martha Hesse. I expect that a more complete record would be established should the Subcommittee wish to seriously consider the bypass issue next year.

My overriding concern with S. 1998 and S. 2313 is that they would significantly retard competition in the natural gas marketplace. To the extent that competition is diminished, both producers and consumers would suffer.

Both bills would effectively eliminate the ability of large natural gas users to obtain from FERC the necessary authorization to buy gas directly from an interstate pipeline, as they can do now under current law. Thus, these bills would discourage, and perhaps eliminate, industrial firms and electric power generation sources from choosing among alternate gas sources for the lowest priced gas possible. This would be costly for consumers.

Worse, because both bills apply to new gas consumers, enactment of either of these bills would discourage construction of new gas-fired industry or electric power generation. Such restrictions are in direct conflict with a sound energy policy, our national energy security and a clean environment. Moreover, such a result would also be in direct conflict with the policy the Congress recently established by repealing the relevant provisions of the discredited Powerplant and Industrial Fuel Use Act.

Finally, it is important to recognize the potential impact of these bills to the California market. Both bills could prejudge the sources and prices of needed new gas supplies. It is generally acknowledged that California has the greatest growth potential for domestic natural gas of any market in the country. Passage of either of these "anti-bypass" bills might significantly dampen the prospects for additional domestic gas sales to the West Coast.

Having only recently labored over massive trade legislation, I am sure that my colleagues are aware that domestic manufacturers, particularly energy intensive commodity manufacturers such as steel, automobiles and chemical manufacturers, are facing intense international competition. They are constrained by the international marketplace from passing on additional energy costs. Thus, if gas prices get too high, they will switch to oil or if feasible, coal. If they cannot switch to another fossil fuel, such as in the case of chemical plants that use natural gas as a feedstock, excessive gas costs will cause the plants to shut down.

For example, in the State of Ohio, Vistron Chemical Company closed its ammonia manufacturing operations during 1982 because Columbia Gas of Ohio was charging about $0.62 per mcf to transport the gas 40 miles from an interstate pipeline to the Vistron plant. This charge was so excessive that it made Vistron's $200 million fertilizer plant uneconomic in the face of Gulf Coast and foreign imports. Columbia Gas refused to lower its charge and the Vistron plant closed. Two hundred and fifty jobs would have been lost permanently had not Vistron been permitted by the FERC grant of a 7(c) certificate to what is now ANR to lay a pipe to connect directly to ANR and avoid Columbia Gas's onerous charge. Eight months later, the Vistron plant was able to reopen its doors. Supply competition achieved by this bypass restored Ohio jobs, helped the balance of trade, helped domestic gas producers--including Oklahoma producers--and increased the competition among fertilizer suppliers to keep farmers' costs low.

It is my understanding that a number of local distribution companies, including MichCon and Atlanta Gas Light, are themselves currently seeking to "bypass" their pipeline suppliers by seeking approval to hookup with alternative interstate pipelines. It appears that MichCon and Atlanta Gas Light and the other LDC's recognize that additional sources of gas will increase competition and lower the price of their gas supplies. These cost savings, if passed on to their customers, could be of significant economic benefit to both residential and industrial consumers in their service area.

However, it seems inconsistent for these same local distribution companies to seek legislation to prohibit any of their customers from also seeking additional gas suppliers in order to obtain more competitively priced gas supplies. I look forward to hearing the witnesses comments on why supply bypass is good for LDC's to engage in, but not appropriate for industrials.

Although the bills before us today appear overlybroad and against the overall national interest, the supporters of the legislation have raised the important issue of whether the FERC has sufficient procedural mechanisms in place to ensure that affected parties are heard and their arguments properly weighed prior to making a determination whether to allow a direct connection between an interstate pipeline and an existing LDC customer. I will be interested in hearing testimony on this point from today's witnesses. I also would like to hear the witnesses' opinions on whether there is any reasonable anticipation of a tide of future applications by industrial users wishing to leave LDC's.

I look forward to hearing the testimony. Thank you, Mr. Chairman.

Statement of
Senator Nancy Landon Kassebaum
September 29, 1988

Mr. Chairman, I am concerned about a federal policy which permits large industrial gas customers to bypass local distribution companies (LDCs) and connect directly with interstate pipelines for the delivery of gas.

Each bypass weakens the LDC system by shifting fixed costs onto a smaller number of remaining customers. Savings achieved by large industrial bypass customers, come at the expense of other industrial customers and of residential and small business customers. These small customers are the "core" customers of all LDCs and look for protection to state utility regulatory agencies.

Integrated local distribution networks are constructed and regulated to provide all customers with reliable service at reasonable rates. Bypass by industrial customers located on interstate pipelines results in higher LDC gas rates to remaining "captive" residential and commercial consumers (as well as the subsequent loss of additional large industrial customers in an inevitable spiral).

While competition is the foundation of our economic system, the nature of state regulated LDCs makes fair and reasonable competition with interstate pipelines impossible. The local distribution system functions regardless of customer size or location. The loss of any customer does not reduce the LDC's obligation to serve all customers and reduces only negligibly the cost of providing such service.

Bypass of LDCs by interstate pipelines and end users should be prohibited so long as LDCs are willing to transport gas without discrimination on the basis of source, ownership, or destination of the gas at rates deemed just and reasonable by state regulatory agencies.

State regulatory commissions rather than federal agencies can best weigh the competing interests in cases of proposed bypass and should be clearly empowered to protect the public interest. This has long been the policy in the case of attempted direct sales by interstate pipeline to end-users. The law should be made equally clear today with respect to bypass of LDC's in the transportation of purchased gas to end users. I therefore support the proposed legislation which would accomplish this objective.

NLK

Senator **Fowler**. We did not introduce Mr. Joel Saltzman, who is the staff counsel, who will be with me this morning, and let me say also to all witnesses in attendance, I have asked Ms. Catherine Cook, General Counsel for the Federal Energy Regulatory Commission—it is a somewhat unusual procedure—usually we have the government testify first and then they go back to work and do not hear the criticisms and suggestions from the public hearing.

She has been gracious enough to be willing to go last this morning after she has heard all of our witnesses, and then we will hear the testimony from her.

Senator Breaux, I thank you very much for your testimony this morning.

Senator **Breaux**. Thank you, Senator.

Senator **Fowler**. Our first panel is Mr. Ted Gerarden, Donelan, Cleary, Wood & Maser in Washington, counsel for the Cascade Natural Gas Corporation, Seattle; Mr. Jerald Halvorsen, President of the Interstate Natural Gas Association of America, located in Washington; and Mr. Nicholas Bush, President of the Natural Gas Supply Association in Washington.

Gentlemen, please heed my request. Because we have allowed almost everybody who sought to testify in the interest of a good public discussion this morning, we do have many witnesses. If you would submit for the record, as all of you know who are experienced testifiers, your statement will be made in general, but I am going to have to try to hold you to 8 or 10 minutes maximum in your statement or we will never accomplish what we have to accomplish this morning.

Mr. Gerarden, would you like to begin.

STATEMENT OF O.M. JONES, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CASCADE NATURAL GAS CORP., AS PRESENTED BY TED GERARDEN, COUNSEL, CASCADE NATURAL GAS CORP.

Mr. **Gerarden**. Thank you. Mr. Chairman, members of the committee, I am Ted Gerarden, attorney for Cascade Natural Gas Corporation. I am appearing today at the request of Mr. O.M. Jones, chairman and chief executive officer of Cascade who was unable to attend this hearing.

Mr. Jones has prepared a full written statement which has been supplied to the committee, and I ask that his statement be entered into the hearing record.

Senator **Fowler**. It will be.

Mr. **Gerarden**. Thank you.

I would like to take a few minutes to highlight some of the points made by Mr. Jones.

Cascade is a mid-sized local natural gas distribution company, an LDC in the states of Washington and Oregon. Cascade has served these territories since the 1950's with natural gas.

Its distribution system is in reality many small systems connected to the Northwest Pipeline Corporation, Cascade's sole source of gas.

Northwest is the pipeline link between gas producers in other states and Canada and Cascade's distribution systems in Washington and Oregon. Cascade serves mostly small cities and towns located along the northwest pipeline rather than large metropolitan areas.

In many cases large industrial customers have located their plants near the northwest pipeline to be close to a reliable source of natural gas for their manufacturing operations. To serve these customers Cascade constructed local distribution systems and, at the same time, offered local natural gas service to homes and businesses in the area. The construction of such systems often is economical only because of the high volume industrial user.

Cascade is a public utility and has an obligation under state law to serve its customers. Cascade has approximately 86,000 residential and small commercial customers, 294 firm industrial customers. In addition, Cascade has 26 interruptible commercial customers and 66 interruptible industrial customers.

The distinction between firm and interruptible customers is important. Firm customers are those like homeowners who have no alternate energy source and must be able to rely on receiving natural gas. Interruptible customers are generally high volume users, commercial or industrial plants which can switch and burn another fuel like fuel oil if the price of natural gas is too high.

I mention that Cascade has 26 interruptible and 66 interruptible industrial customers. This group of 92 interruptible customers are the high volume users of Cascade system, and they account for most of Cascade's gas service.

Bypass is of great concern to Cascade because many of Cascade's interruptible customers are located near the northwest pipeline. Cascade has determined that 47 of the 92 interruptible customers are close enough to the pipeline to be candidates to bypass Cascade.

In 1987 these 47 customers accounted for 63 percent of Cascade's throughput, 45 percent of its revenues. As the study attached to Mr. Jones's statement shows, if these customers bypass Cascade, Cascade's rates to its other customers would rise by nearly 24 percent.

The costs saved by the few lucky enough to be near the northwest pipeline will be paid by those not lucky enough to be able to bypass, including the average homeowner and shopkeeper.

There are other impacts of bypass on environment, on employment, et cetera, in local areas. The local commissions now are unable to have any say about these consequences.

Cascade is interested in the bypass issue because Cascade is being bypassed by Chevron Chemical Company in Kennewick, Washington. This bypass is occurring because Chevron has built a one-mile pipeline to connect to a northwest pipeline delivery point, and Northwest is transporting gas directly to Chevron.

Cascade, which had served the Chevron Kennewick plant since 1959, promptly complained to FERC, that the transportation that Northwest Pipeline is using for this bypass is illegal. But Cascade's complaint fell on deaf ears. On July 19th, Cascade's bypass complaint was summarily dismissed by FERC.

Indeed on July 19th——

Senator FOWLER. Pull that microphone a little closer to you.

Mr. GERARDEN. Indeed on July 19th FERC issued four separate orders that, taken together, mean first, immediate and automatic transportation is available to any end user. Two, pipelines must accept any end user's gas for transportation. And, three, they must continue to transport it for a long term.

These cases make bypass easy, not only because there is no FERC review of whether bypass is in the public interest, but also because pipelines have been told they must transport the gas.

Cascade believes that these orders do not reflect Congress' intent in the Natural Gas Act and the Natural Gas Policy Act and has sought rehearing from FERC. These orders are now pending before the FERC on rehearing.

Cascade is frustrated by FERC's new policy. In order 436 FERC said that LDC's could avoid bypass by taking advantage of transportation and pipelines to buy lower cost gas. Cascade has done this. Cascade buys spot gas at prices substantially lower than Northwest's and passes the savings on to its customers.

Cascade will also transport gas for a customer under state-approved rates. But end users can find and buy the same cheaper gas supplies Cascade can find. They pay Northwest the same rates Cascade has to pay for transportation. It simply isn't possible to beat those prices and still charge the State-approved rate for moving gas on Cascade's distribution system.

The orders issued July 19th are a change from past FERC policy in which bypasses were examined on a case-by-case basis. Now they are done without any FERC review. Indeed, as the summary denial of Cascade's complaint makes clear, FERC simply will not look at any bypass transaction.

At the same time, the States are excluded from any role in deciding whether a bypass is in the public interest. If a pipeline made a direct sale to an end user, the state commission would have jurisdiction, would have a say in the matter. But with bypass transportation, the sale to the end user occurs in a distant state, and it leaves the local state commission powerless.

In essence, bypass under FERC's new policy is unregulated. FERC will not regulate it, and the states cannot regulate it.

The frustration of the state commissions was expressed directly to FERC recently by the Washington Utilities and Transportation Commission. In a letter from the three WUTC Commissioners to FERC, the WUTC fully supported Cascade's efforts to halt the Chevron bypass and have a hearing to investigate its lawfulness.

In the course of that letter WUTC expressed its frustration as follows, and I am quoting from their letter: "If the FERC order stands, it suggests that virtually any bypass of local distribution companies' service could be accomplished without review by either state authorities or the FERC."

The commission continued, "Northwest has not applied to the WUTC for authorization to provide service, displacing the service previously rendered by Cascade to Chevron. FERC's summary dismissal of Cascade's complaint confirms that there will be no federal review of such implementing bypass on a case-by-case basis."

Senator **Fowler**. As one lawyer to another, I bet you can now summarize in 2 minutes.

Mr. **Gerarden**. Yes, sir, I can.

I might add the pipelines are not unwilling participants in the bypass. The high volume industrial customers are the desirable customers. They take lots of gas, and they pay their bills.

Pipelines are also encouraged to cherry-pick these customers because in essence they are being paid twice. They are paid once by the end user who receives bypass transportation, but they are paid by the local distribution company that has a firm contract with the pipeline and has to pay demand charges.

And that is the situation with Cascade. Cascade is paying Northwest Pipeline demand charges for gas it bought to serve Chevron, but that gas is being moved for Chevron's account on the bypass transaction. Northwest is being paid again by Chevron.

The situation cries out for corrective legislative action. FERC will not provide responsible regulation of bypass. We believe the legislation pending before this committee would give the state commissions a role in deciding whether bypass would be prejudicial on LDC's systems. That is where this decision belongs.

State commissions are the best of judge of whether the public interest is served by a price advantage for one lucky industrial customer. State commissions can take all the pertinent facts and their impact on local areas into account.

Likewise, because the LDC must be willing to transport under this legislation, the State commission can fashion rates and terms and conditions of service to meet the industrial customer's need.

We need the legislation to impose a local solution on these local problems. Thank you very much.

[The prepared statement of Mr. Jones follows:]

UNITED STATES OF AMERICA
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

STATEMENT OF

O.M. JONES

Chairman and Chief Executive Officer,

CASCADE NATURAL GAS CORPORATION

RESPECTING S. 1998 and S. 2313

Cascade Natural Gas Corporation
222 Fairview Avenue North
Seattle, Washington 98109

September 29, 1988

EXECUTIVE SUMMARY

Cascade supports the dual goals of maintaining the role of local distribution companies ("LDCs") in providing essential utility service to all customers at the lowest possible cost, and of encouraging greater competition in the natural gas industry. Recent decisions by the Federal Energy Regulatory Commission ("Commission"), however, have opened the door to virtually automatic bypass of LDCs without any review by the Commission of whether such bypass transactions are in the public interest.

Cascade is highly vulnerable to bypass, and the cost consequences of widespread bypass are substantial. On the Cascade system, bypass by the large industrial customers would cause a shift in cost responsibility among classes of customers of more than $20 million, and would raise residential customers' rates by nearly 24%. The risk of bypass is real. Cascade already is being bypassed by a major industrial customer which has built its own pipeline to obtain service directly from Cascade's interstate pipeline supplier, Northwest Pipeline Corporation ("Northwest Pipeline"). Moreover, Cascade is aware of two other industrial end-users arranging for gas supply to be delivered directly by Northwest. As a result of recent Commission action encouraging bypass, many more bypasses may soon appear.

In July 1988 the Commission issued four related decisions which announced a broad interpretation of the "on behalf of" test in Section 311 of the Natural Gas Policy Act. Under these orders any LDC or intrastate pipeline is a qualifying "on behalf of" entity if it receives "some economic benefit." The Commission used this interpretation to summarily deny a verified complaint by Cascade that the Section 311 transaction bypassing it is illegal. At the same time, the Commission instructed pipelines that they cannot refuse to accept questionable "on behalf of" transactions and that they cannot terminate any Section 311 transportation so long as a firm sales customer has converted to transportation. The total effect of these orders is to encourage pipelines and industrial customers to bypass LDCs.

The public interest has been well served by a policy whereby service to residential and commercial customers in small towns and communities is facilitated by construction of local distribution facilities to industrial end-users. Removal of large volume users from the system will inevitably force the cost to residential and small commercial customers to increase sharply, to the detriment of all concerned. The pending legislation restores perspective by recognizing the important role State and local regulators must play in determining whether a bypass which has serious economic impact on captive customers in a local service area should be permitted. State and local regulators are in the best position to determine the direct consequences of bypass on their communities.

UNITED STATES OF AMERICA
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

STATEMENT OF
O.M. JONES, Chairman and Chief Executive Officer,
CASCADE NATURAL GAS CORPORATION
RESPECTING S. 2313 AND S. 1998

Mr. Chairman and members of the Committee, I am O.M. Jones, Chairman and Chief Executive Officer of Cascade Natural Gas Corporation ("Cascade"). Cascade is a local natural gas distribution company in the States of Washington and Oregon. I am presenting this statement in support of S. 2313, a bill to coordinate the authority of the Federal Energy Regulatory Commission ("Commission") with that of State or local regulatory agencies, as such authority relates to interstate pipeline natural gas service that bypasses local utility service to end-users.

Cascade supports enactment of S. 2313 as needed to achieve the correct balance between federal and local regulation of the natural gas industry. The bill is also needed to balance the sometimes conflicting goals of maintaining the role of local distribution companies ("LDCs") in providing essential utility service to all customers at the lowest possible cost while encouraging greater competition in the natural gas industry.

S. 2313 will fill a gap being left by recent Commission decisions which allow interstate pipeline companies to use self-implementing transportation authority to bypass LDC service to industrial end-users. Given the current restructuring of the natural gas industry, including broad reliance on self-implementing transportation and the unbundling of sales and transportation services by interstate pipeline companies, end-users are now able to purchase gas in distant regions of the country and to arrange for the transportation of such gas by interstate pipelines directly to their facilities. The Commission's decision to permit such transportation without any prior determination of whether it is in the public interest will make widespread bypass possible. The emergence of these arrangements, however, leaves State and local regulatory authorities with fewer opportunities to exercise authority over sales of natural gas to end-users and over the consequent impact on LDCs service to their remaining customers.

S. 2313 would make clear that State or local regulatory authorities have a role to play in determining whether a bypass--with its consequent economic impact on captive customers in the local service area--should be permitted. At the same time, S. 2313 emphasizes the need for LDCs to be willing to provide transportation service to permit end-users to acquire their own supplies for delivery through the facilities of local utilities, thereby enhancing competition for the acquisition of gas supply. This, of course, furthers a principal purpose of the Natural Gas Policy Act ("NGPA").

Cascade also supports the purposes of S. 1998 as stated in Section 2(b) of that bill, and would support its enactment if S. 2313 were not enacted. Cascade prefers S. 2313, as it provides expressly for a determination by the State or local commission whether a particular proposed bypass is in the public interest. In this respect, Cascade believes that S. 1998 does not strike the best balance between State and Federal regulatory authority. Cascade strongly supports the notion that the State or local regulatory authorities are in the best position to assess the present or future interests of the customers of the affected LDC, and that a certificate that those interests would be prejudiced should be dispositive on whether a bypass is allowed. Consequently, Cascade supports S. 2313 as the preferred vehicle for effective regulation over bypass.

Cascade's interest in this issue is not based on a hypothetical notion of how the marketplace should work or an academic debate over transnational competition. Cascade has begun feeling the real effects of bypass and Commission neglect. Cascade is currently being bypassed by Chevron Chemical Company ("Chevron") and requests to the Commission for case-specific review of the transaction have been summarily rejected. As a result, Cascade fears that the Commission has given strong signals to other industrial customers--as well as potential customers that have been in negotiation with Cascade--that bypass is not only acceptable but desirable. In at least two circumstances in addition to and since the Chevron matter, Cascade is being threatened by bypass, and Cascade believes that the eyes of the industry are focused upon the government's response. The consequences of bypass--industrial flight from LDCs--is harmful not only for those companies, but also for the millions of small commercial and residential users who will ultimately bear the burden of bypass. The signals the Commission is sending will make bypass the rule and not the exception, unless legislation is passed to inject equity and fairness back into the system.

The following discussion of reasons in support of corrective legislation will be divided into two parts. First, Cascade will discuss the consequences of bypass in the context of Cascade's utility operations. Cascade will explain the risk involved in large industrial customers bypassing service from Cascade in favor of direct delivery of gas from Cascade's interstate pipeline supplier, Northwest Pipeline Corporation ("Northwest Pipeline"). Cascade will show the magnitude of this risk and the impact that loss of such customers will have on the cost of service to the remaining "core" residential and commercial customers on the Cascade system. Finally, Cascade will discuss its own experience with bypass on its system.

Second, Cascade will show that the Commission has abandoned its responsibility with respect to carrying out the Congressional intent of the NGPA. Cascade will demonstrate how the Commission, in decisions issued in July 1988, has abdicated its regulatory authority in this critical area by emasculating the "on behalf of" requirement of NGPA section 311(a)(1). As a consequence, the Commission has placed exclusive reliance on economic theory and has refused to consider whether bypass-

-including the bypass Cascade is experiencing--is in the public interest of all affected natural gas consumers.

I.

THE CONSEQUENCES OF BYPASS

Facts about Cascade

Cascade is a corporation organized and existing under the laws of the State of Washington and it is duly authorized to do business in the States of Washington and Oregon. It is headquartered in Seattle, Washington. Cascade is a public utility engaged in distribution and sale of natural gas in intrastate commerce in 86 communities in the states of the Washington and Oregon, and is subject to the jurisdiction of the Washington Utilities and Transportation Commission and the Public Utility Commission of Oregon. Cascade's entire gas supply for its distribution operations in Washington and Oregon is supplied, either by sales or transportation, by Northwest Pipeline. Cascade is entirely dependent upon Northwest Pipeline to transport gas suppliers from the wellhead in other states or from the Canadian border to Cascade's distribution facilities in Washington and Oregon. Cascade's system is in reality physically separate distribution systems linked to Northwest Pipeline and to another interstate pipeline which delivers gas to Cascade for the account of Northwest Pipeline. A map of Cascade's distribution system is attached as Exhibit A hereto.

In many instances, industrial end-users with significant natural gas requirements have located their plant facilities near Northwest's pipeline to have ready access to gas supply. Over the years, Cascade has provided distribution service from Northwest to industrial end-users under tariffs approved by state regulatory authorities. In many instances, the construction of facilities to provide residential and commercial service in small towns and communities was feasible only because Cascade was also able to provide distribution service to large industrial users.

This pattern of bringing the benefits of natural gas service to residential and small commercial enterprises in relatively small service territories is only made practical by providing service to the industrial end-users located therein. Cascade's situation certainly is not unique, and the consequences of bypass that can be illustrated by using the facts and figures on the Cascade system are representative of the consequences that face many LDCs across the country.

Sales and Transportation Services Provided by Cascade

In 1987, Cascade sold approximately 462 million therms of gas and transported another 17 million therms.[1] Of the 462 million therms of sales gas, approximately 325 million therms, or 70% of Cascade's sales, represented sales to industrial end-users. The greater part of this sales volume, 241 million therms, represented interruptible industrial end-use sales. The pattern over the past ten years of Cascade's operations shows a steady decline in firm industrial sales and a corresponding increase in interruptible industrial sales. This is the result of increasing capability on the part of industrial end-users to switch from natural gas to one or more alternate fuels when natural gas prices are not competitive.

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[1] Cascade's sales and transportation services are measured in therms, the heat content of natural gas which is equal to one-tenth of an MMBtu.

LDCs are adapting with ingenuity to the changes taking place in the rapidly developing natural gas market. Cascade is not unlike other LDCs in terms of finding creative solutions for maintaining its competitive position. But bypass is not part of a healthy new competitive environment. Chevron's bypass of Cascade, along with similar bypass of other LDCs, represents a testing of the regulatory waters to see whether the Commission would exercise its discretion in a responsible and equitable way, or whether it would act to open the floodgates to end-users all over the country which are in a position to bypass LDCs. The Commission chose the latter route. Because of it Cascade, and other similarly situated LDCs, are facing potentially devastating effects. Since the Chevron bypass, two other end-users have taken steps leading to bypass of Cascade, an ominous sign of the future flight of these end-users.

Historically, of course, Cascade and other LDCs purchased gas from pipelines and sold it to their end-user customers, including large industrial customers. More recently, Cascade has been able to provide transportation service for industrial customers which acquire their own gas supplies. Cascade first provided transportation service for an industrial end-user in February 1982. Ironically, the custom was

Chevron.[2] Cascade broadened the availability of such service in 1985 and has transported steadily increasing quantities of gas since. The transportation services are available, of course, only when transportation can be obtained from Northwest Pipeline.

Cascade's efforts to provide the flexibility of transporting customer-owned gas has been hampered until recently by a lack of permanent transportation on the Northwest Pipeline system. For many years, only very limited certificated transportation service has been available. Over the past two years, Northwest Pipeline has opened its system for NGPA Section 311 transportation service on three occasions, and Cascade also has received some transportation service through a limited term certificate.[3] Cascade has made use of these opportunities both to purchase alternative gas supplies at lower cost than those available from Northwest Pipeline, and to act as agent for end-users wishing to purchase their own supplies and to have the gas transported both by Northwest Pipeline and Cascade. It is ironic that Cascade, which stood ready to transport gas even before Northwest Pipeline was willing, is now the victim of Northwest Pipeline's recent willingness to transport gas directly to end-users.

The on-again, off-again transportation situation on Northwest Pipeline has now changed to permanent transportation. Northwest

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[2] Cascade actually agreed to transport gas for Chevron in October 1980, but Chevron was unable to get Northwest Pipeline to provide the necessary interstate transportation until February 1982.

[3] Northwest Pipeline Corp., 39 FERC ¶61,092 (1987).

Pipeline had made efforts to implement blanket certificate transportation by submitting an Order No. 436 settlement to the Commission. In February 1988, Northwest Pipeline began its third stint of open-access transportation under NGPA Section 311, while the Commission considered issues on rehearing of a blanket certificate order. Following action by the Commission on rehearing, Northwest Pipeline accepted its blanket certificate on June 10, 1988. NGPA Section 311 transactions already underway, including the transportation of gas to Chevron which bypasses Cascade, have continued. Indeed, Northwest Pipeline has informed prospective shippers that it will continue to offer new NGPA Section 311 transactions, that is, that it will offer transportation under NGPA Section 311 rather than the newly accepted blanket certificate if the shipper prefers.

As part of its implementation of open access transportation, Northwest Pipeline offered all of its sales customers the opportunity to convert firm sales contract demand ("CD") to firm transportation. Cascade availed itself of that opportunity, converting 144,523 MMBtu per day of sales CD to firm transportation, some 70% of the firm sales service it has under contract with Northwest Pipeline. Cascade made this conversion effective July 1, 1988. As a result of its conversion, Cascade is continuing to purchase less expensive supplies of natural gas for its customers, and to have such gas transported by Northwest Pipeline.

Cascade had an average of 87,404 firm customers in 1987. This was composed of 70,752 residential customers, 16,266 commercial customers, and 294 industrial customers. In addition, Cascade had 26 interruptible commercial customers and 66 interruptible industrial customers. Because sales to interruptible commercial and industrial customers account for the greater part of Cascade's sales, these 92 customers are of great importance to the economic viability of Cascade's service to its firm residential and commercial customers.

In 1987 the average consumption by residential customers was 685 therms of natural gas, and for commercial customers, 4,619 therms. By contrast, the average consumption of the 26 interruptible commercial customers was 518,009 therms of gas, and of the 66 interruptible industrial customers, 3,649,523 therms. In addition, 17 million therms were delivered to some of these interruptible industrial customers through transportation on the Cascade system.

The physical proximity of many of these industrial end-users to the Northwest Pipeline system and the high volumes of gas which they consume make them attractive candidates for a bypass of Cascade's distribution service. Recognizing this, Cascade has worked actively with its State regulatory authorities, its customers, Northwest Pipeline, and many gas suppliers to provide flexible and lower cost service to its customers.

Bypass is a reality, however, and Cascade believes that the Commission's unconcerned attitude has already resulted in encouraging a potential customer in Cascade's service territory to drop negotiations for service by Cascade and link up directly with Northwest Pipeline. Despite its best efforts to use transportation on the Northwest system to provide lower cost gas service to its customers, Cascade, as well as many similarly situated LDCs, are expecting devastating consequences if Congress does not renounce the hands-off approach the Commission has taken on bypass. It is important to note in this respect that S. 2313 does not renounce all bypass. Rather, the legislation serves to allow balanced participation by those most likely to have first hand knowledge of the effects of any proposed bypass--the State and local regulatory agencies.

Cascade is willing ~~and able~~ to provide alternate sources of gas to its large industrial customers. When transportation has been available from Northwest Pipeline, Cascade has purchased lower cost gas for its system supply from alternate suppliers. Cascade has used these lower cost supplies to lower its sales rates to certain classes of customers under tariffs on file with and approved by state regulatory authorities. In addition, where end-users have preferred to purchase their own gas supplies (and when transportation has been available on the Northwest Pipeline system), Cascade has transported the end-users' gas through Cascade's distribution system, charging a rate on file with and approved by State regulatory authorities.

These steps are the very ones that the Commission has indicated that local distribution companies should take to avoid being bypassed. In Order No. 436-A, FERC Stats. & Regs. (1982-85 Transfer Binder) ¶30,675, p. 31,696 (1985), the Commission said: "new NGPA Section 311 transportation will allow distributors to avoid being bypassed . . . , as the local distribution companies themselves can locate lower priced gas for their customers and require that the pipeline transport the gas to the local distribution companies for distribution to the end-users."

As a practical matter, where an industrial end-user is located near Northwest's pipeline, as is frequently the case on Cascade's system, there is a minimal cost to the industrial end-user in constructing its own pipeline directly to Northwest Pipeline. In this evolving natural gas market, end-users are able by themselves (or through the services of marketers) to locate the same less expensive gas supplies that Cascade is able to purchase, and to arrange transportation of those supplies by Northwest Pipeline at the same basic rates Northwest Pipeline charges Cascade. It is simply impossible for Cascade, or for any LDC in a similar position, to charge any margin for the distribution of natural gas to an industrial end-user and, at the same time, provide the service at no greater cost than if the industrial end-user is purchasing gas directly and bypassing Cascade.

The economies of scale that service to large industrial companies permits is critical for the competitive viability of distribution companies like Cascade. It further ensures the added public policy benefits of wider distribution to small commercial and residential customers and lower costs to all end-users. With the loss of large industrial users due to bypass, local distribution companies face escalating costs with no ability to compete effectively. Focusing exclusively on the economics of the industrial end-user distorts the greater public good inherent in a system that produces economic and non-economic benefits for all end-users. The viability of a strong competitive system which promotes development of natural gas resources and low cost service to all customers is consistent with Congressional policy, and would be furthered by enactment of S.2313.

The Cost of Bypass

Bypass is totally at odds with the traditional notion that service to industrial end-users makes feasible the construction of distribution facilities, with the concomitant extension of natural gas service to residential and small commercial customers in small towns and communities. Removal of the large volume user from the system will inevitably force the cost to residential and small commercial customers to increase sharply. In Cascade's situation, there are 47 industrial end-users located such that a direct connection to Northwest Pipeline by these end-users could be economically feasible. The table attached as Exhibit B to this statement illustrates the cost consequences of bypass by these major end-users.

These 47 high risk end-users accounted for 299 million therms of sales and transportation by Cascade in 1987, or approximately 63% of Cascade's throughput. In terms of revenue, the 47 bypass risks contributed $68.4 million in revenue, some 45% of Cascade's total revenue of $152.2 million, in 1987. Excluding from this revenue the portion attributable to gas cost and transportation by Northwest Pipeline, the potential margin loss to Cascade is about 20 million dollars, a substantial portion of Cascade's non-gas cost of service. Apportioning this loss of revenue across all other system customers,[4] there would be a 23.8% increase in such customers' rates.

Looking first at the dollar impact on residential customers, the average customer uses 57 therms per month, or 685 therms per year. The monthly bill for this service is $32.21. With the cost shift that widespread bypass would cause, however, the average bill would rise to $39.23 per month, an increase of $7.02 monthly, or $84.24 per year.

As for commercial customers, the average customer uses 385 therms per month, or 4,619 therms per year. The monthly bill for this service is $184.20. With the cost shift that widespread bypass would cause, however, the average bill would rise to $231.56 per month, an increase of $47.36 per month, or $568.32 per year.

As for the remaining industrial customers, the average customer uses 6,796 therms per month, or 81,554 therms per year. The monthly bill for this service is $3,149.86. With the cost shift that widespread bypass would cause, however, the average bill would rise to $3,985.98 per month, an increase of $836.12 per month, or $10,033.44 per year.

A further point must be made about these figures in respect of the remaining industrial users. As prices for Cascade's service increase, these customers and the larger commercial customers can be expected to invest in fuel-switchable equipment and to switch to alternate fuels if the price of natural gas is too high. Fuel switching by such customers would further reduce the customer base over which Cascade must collect its cost of service, leading to further increases in the charges for residential, commercial, and industrial service.

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[4] Consisting of 1987 year-end totals of 73,910 residential customers, 16,714 commercial customers, and 349 industrial customers for whom bypass is not deemed economic under present conditions.

Cascade Is Presently Being Bypassed

As noted earlier, Cascade is presently being bypassed by an industrial customer, Chevron. Promptly upon learning that Northwest Pipeline had begun transporting gas used by Chevron to bypass Cascade, Cascade filed a verified Complaint with the Commission.[5] Cascade's complaint has been summarily dismissed by the Commission,[6] and is currently pending before the Commission on rehearing.[7] This bypass has been accomplished without any prior consideration of the matter by the Commission and without any meaningful opportunity for Cascade to defend its interests and the interests of its other customers in maintaining the historical service it has rendered to Chevron.

The facts of Chevron are relatively straightforward. Chevron owns and operates two industrial plants in Washington which are separate but located close to one another. Cascade has served one of the plants (the "Kennewick plant") from the time of its construction by Chevron in 1959 until the present bypass. Chevron receives gas for its other plant (the

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[5] Cascade Natural Gas Corp. v. Northwest Pipeline Corp., et al., Docket No. CP88-286-000 (filed March 9, 1988).

[6] "Order Denying Complaint," 44 FERC ¶ 61,081 (July 19, 1988).

[7] Filed August 18, 1988 with the Commission.

"Finley plant") directly from Northwest Pipeline as successor in interest to CEPEX, Inc., from whom Chevron purchased the plant. After acquiring the Finley plant in 1986, Chevron constructed a one mile, three inch diameter high pressure pipeline between the Finley and Kennewick plants. Chevron has freely admitted that it has arranged for gas to be transported by Northwest Pipeline to the Finley plant, and that it is transporting gas through its own new pipeline from the Finley plant to the Kennewick plant.

On March 1, 1988, Chevron began diverting gas taken from Northwest Pipeline at the Finley plant to the Kennewick plant, and stopped taking service from Cascade. Cascade learned of this bypass through a handwritten note left by unnamed Chevron personnel on Cascade's meter, when Chevron shut off Cascade's delivery line to the Kennewick plant. A copy of this "Dear John" note is attached as Exhibit C hereto. The gas diverted at Finley is gas transported by Northwest Pipeline under NGPA Section 311 "on behalf of" third parties whose only apparent connection to the transaction is providing, for a fee, a letter stating that their name can be used as an "on behalf of" entity. The effect of the transaction is that Chevron is bypassing the service Cascade has long rendered to it. Indeed, Cascade originally contracted for 11,500 therms per day of firm sales service in order to supply Chevron's Kennewick plant. Cascade remains obligated to Northwest Pipeline for the demand charges associated with this firm capacity, at an annual cost of approximately $69,000. At the same time, the bypass by Northwest

Pipeline is causing Cascade to lose approximately $24,400 per month, or nearly $300,000 per year, in net revenues.

On March 9, 1988, Cascade filed a verified complaint with the Commission, challenging the lawfulness of the Section 311 transportation Northwest Pipeline has relied upon to transport gas for Chevron. Cascade argued, inter alia, that the "on behalf of" entity relied upon, a Wyoming company, did not have a sufficient interest in the transaction to meet the statutory requirement for exemption from Section 7 of the Natural Gas Act ("NGA"). At the same time, Cascade intervened in and protested a request for a declaratory order filed by Hadson Gas Systems, Inc. ("Hadson").[8] Hadson had requested the Commission to issue an industry-wide interpretation that the "on behalf" test found in NGPA Section 311 would be met if any shipper entered into any "agency" arrangement with any LDC or intrastate pipeline.

As events unfolded after Cascade filed its complaint, additional "on behalf of" entities were identified by Northwest Pipeline.[9] One was an intrastate pipeline in New Mexico, another an intrastate pipeline in Corpus Cristi, Texas. As recently as September 22, 1988, Cascade received another notification from Northwest Pipeline that another Section 311 transaction is beginning, this time "on behalf of" a Wyoming intrastate pipeline. To Cascade's knowledge, the only direct interest these distant

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[8] Docket No. GP88-11-000, filed February 2, 1988.

[9] Northwest is obligated to notify the affected State commission and LDC of self-implementing transportation to a customer in the LDC's service territory. 18 C.F.R. §284.106 (a) (4).

"on behalf of" companies have in the transportation of gas to Chevron is receipt of payment for the use of their name as the "on behalf of" entity.

The Commission's response to Cascade's complaint, a matter of intense interest to many industrial end-users, was one of sheer indifference. Based upon a broad declaratory order issued in the Hadson case, Cascade's complaint was summarily denied. The Commission refused to make any assessment of impact or potential impact on Cascade and its remaining customers. There was no discussion of the loss of revenue to Cascade or of concern for the residential end-user. Rather, the Commission relied on a virtually meaningless generic test for the "on behalf of" requirement of section 311 of the NGPA, and proceeded to apply it in a mechanical way. The Commission's handling of these cases, Cascade submits, flies in the face of Congressional intent and encourages future bypass.

The Commission Refuses To Consider Whether Bypass Is In The Public Interest

The Commission issued four orders on July 19, 1988, which, taken together, permit virtually unfettered use of NGPA Section 311 for the transportation of gas in interstate commerce that bypasses local utility service. These cases are: (1) Hadson Gas Systems, Inc., 44 FERC ¶61,082 (1988)("Hadson"); (2) Texas Eastern Transmission Corp., 44 FERC ¶61,080 (1988)("Texas Eastern"); (3) Cascade Natural Gas Corp., 44 FERC ¶61,081 (1988)("Cascade"); and (4) Algonquin Gas Transmission Co., 44 FERC ¶61,078 (1988)("Algonquin").[10]

The Commission's new approach as reflected in these cases sweeps away in one stroke the concern for and protection of the public interest that originated in Section 7 of the NGA. The Commission effectively has abandoned its obligation to provide a review of the public convenience and necessity of transactions--like the ones Cascade has complained of--that present serious questions of equity and market raiding.

NGPA Section 311 authorizes an interstate pipeline to perform self-implementing transportation only if such transportation is "on behalf of" a LDC or an intrastate pipeline. Although the precise scope of this requirement might be open to some interpretation, Congress obviously intended some meaningful limitation in the context of the gas markets as they existed in 1978. At the very least, the phrase "on behalf of" implies that an LDC or intrastate pipeline will be a real party in interest in the transportation transaction. A brief summary of the four orders shows how, taken together, they expand the scope and impact of NGPA Section 311.

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[10] Cascade is a party to the Hadson and Cascade cases. On August 18, 1988, Cascade sought rehearing of these two orders. The Commission granted rehearing solely for the purposes of further consideration in Hadson, Docket No. GP88-11-001 (issued Sept. 19, 1988), and Cascade, Docket No. CP88-286-000 (issued Sept. 19, 1988). Other parties sought rehearing of the Algonquin and Texas Eastern orders. The Commission granted rehearing solely for the purposes of further consideration in Algonquin, Docket No. RP87-73-005 (issued Sept. 16, 1988) and Texas Eastern, Docket No. RP 88-175-001, et. al. (issued Sept. 15, 1988).

In Hadson, the Commission ruled that any LDC or intrastate pipeline will qualify as an "on behalf of" entity if it derives "some economic benefit" from the transaction. In Cascade's case, each "on behalf of" entity to the Chevron bypass has been an out-of-state company that merely received a fee for providing an "agency" to satisfy the "on behalf of" requirement of the statute. The Commission's interpretation of the statute is meaningless, since it results in obscure parties with no substantive interest in the transaction to "authorize" it by selling the use of their company's name for token fees. Such sham transactions were surely not intended by Congress to qualify under the NGPA Section 311.

In Texas Eastern, the Commission required Texas Eastern to delete a slightly more restrictive requirement for meeting the "on behalf of" test, then instructed the pipeline to transport gas even if it doubts the transaction qualifies under the Hadson decision. In other words, the Commission is requiring pipelines to accept transportation arrangements and move the gas pending an unspecified resolution of whether the transportation actually qualifies under Section 311 for exemption from NGA Section 7 certificate requirements.

In Cascade, the Commission summarily rejected a detailed and verified complaint that the Chevron bypass was being done through transactions not qualifying under NGPA Section 311. For the first time, so far as Cascade is aware, the Commission permitted a contested bypass without first deciding if the bypass is in the public interest. The decision illustrates that the notice requirement in 18 C.F.R. §284.106(a)(4) is meaningless, as the Commission will refuse to review such cases. It also shows that the Commission's assumption in Order No. 436-A that LDCs could use transportation by pipelines to avoid bypass is false.

In Algonquin, the Commission reviewed tariff sheets implementing Section 311 transportation. Because under Commission rules customers can now convert from firm sales to an equal term of firm transportation when a pipeline offers Section 311 service, and because withdrawal from Section 311 service must be non-discriminatory, the Commission held that Algonquin must transport under Section 311 for any shipper for at least as long as the longest term remaining in a converted sales contract.

In short, an end-user now can purchase a gas supply, pay any willing LDC or intrastate pipeline entity for an "on behalf of" letter, require a pipeline to transport the gas, be entitled to transportation for a substantial period of time, and use the gas to bypass an LDC without any review or prior authorization from the Commission.

The Hadson order represents a departure from the Commission's past practice in at least three respects. First, it represents a decision by the Commission that market forces alone are determinative of the public interest when a transaction would bypass service historically provided by an LDC. In the past, of course, the Commission has supported service to industrial end-users through local distribution companies as a matter of sound public policy.[11] It simply is not sound public policy to permit pipelines to skim off industrial markets, leaving residential and small commercial customers to bear all of the fixed costs of a distribution system.

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[11] See, e.g., Panhandle Eastern Pipe Line Company v. Michigan Public Service Commission, 341 U.S. 329 (1951); Panhandle Eastern Pipe Line Company, Opinion No. 274, 13 FPC 301 (1954), aff'd 232 F.2d at 467 (3rd Cir. 1956), cert. denied, 352 U.S. 891 (1956).

The Commission's more recent bypass decisions have signaled a new course.[12] Prior to Hadson, however, Commission decisions on bypass have been reached on the basis of facts specific to each case and a weighing of the public interest in allowing LDC service to be bypassed. Now, by permitting virtually unlimited use of NGPA Section 311 and by its decisions in Cascade and Texas Eastern, the Commission is refusing even to consider the balance of the public interest in permitting bypass. The Commission is sending a clear signal that shippers can pay any willing LDC or intrastate pipeline anywhere in the country a minimal fee to rent their name, and proceed to bypass service by the LDC authorized to serve the area in which the end-user is located. No consideration will be given to the impact on other customers served by the LDC, or to the options for service the affected LDC is willing to offer the end-user.

The latter point illustrates the self-contradictory approach the Commission is taking to bypass. In Order No. 436-A the Commission said that LDCs can retain industrial loads by taking advantage of transportation on the pipeline. Cascade has done just that, as explained earlier. Now, however, the Commission's broadened view of the "on behalf of" test in Hadson is used in Cascade to justify a refusal to examine the facts of a bypass that is occurring despite Cascade taking the very steps the Commission has recommended.

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[12] See, e.g., Panhandle Eastern Pipeline Co., 40 FERC ¶61,220 (1987).

The significance of the Commission's shift in policy as reflected in the Hadson order can be seen by comparing Hadson to Order No. 436. In Order No. 436, the Commission stated its view that blanket certificate transportation held greater threat of bypass to LDCs than did Section 311: "such [Section 311] transportation does not raise the same concern for bypass of an LDC since normally the transportation will be "on behalf of" the affected LDC." FERC Stats. & Regs. (1982-85 Transfer Binder) ¶30,665, p. 31,554 (1985). Now, however, the Commission clearly embraces the notion that any LDC or intrastate pipeline anywhere in the county can be an "on behalf of" entity facilitating bypass.

A second respect in which the Commission has broken new ground is the breadth of its interpretation of the "on behalf of" test. From its statutory origin as a means of allowing intrastate gas to flow in interstate commerce without subjecting affected LDCs and intrastate pipelines to jurisdiction under the NGA, the Commission has now interpreted the device to permit virtually unlimited avoidance of the public interest standard of the NGA for any transaction, including the movement of purely interstate gas. Where before most "on behalf of" entities were either LDCs moving gas to their systems or intrastate pipelines moving intrastate gas to interstate pipelines for transportation in interstate commerce, "on behalf of" entities now will be those LDCs and intrastate pipelines willing to sell the use of their names for the lowest price--and whose only connection to the transaction is receipt of the token payment.

A third problem area concerning the Commission's new reading of the "on behalf of" test is that in effect it voids any need for pipelines to obtain a public interest determination regarding when transportation of interstate gas is in the public convenience and necessity. The Commission's interpretation of the "on behalf of" provision differentiates between transportation under a blanket or regular NGA Section 7 certificate and transportation under NGPA Section 311. Despite the fact that the Commission established notice procedures applicable to Section 311 transactions, the decision in Cascade undermines them. Under 18 C.F.R. §284.106 (a)(4), a pipeline is supposed to provide the affected LDC and the State Commission with notice prior to commencement of transportation into the LDC's service area. The denial of the complaint in Cascade has made this notice requirement meaningless, since the notice does not entitle the affected LDC to a protest procedure, to an opportunity to be heard, or lead to a case-specific review and determination by the Commission of whether the transportation is in the public interest. Contrary to transportation under NGA Section 7(c) certificates or under a blanket certificate, NGPA Section 311 does not provide for any procedure which would allow affected parties to voice their objections to the transaction and entitle them to be heard on the merits. In short, Section 7 of the NGA and blanket certificates are now irrelevant, as any shipper who can turn up an LDC or intrastate pipeline company willing to sell the use of its name can get service with no review of whether that transportation--which in Cascade's case displaces nearly 30 years of service--is in the public interest.

In the Hadson declaratory order, the Commission said that its new pronouncement "is consistent with the language of the statute and the Commission's orders construing the 'on behalf of' test . . . ." The Commission is deluding itself. ~~The po~~licy announced in the Hadson declaratory order and the order denying Cascade's Complaint is breaking significant new ground by using NGPA Section 311 for purposes never envisioned by Congress, and by opening the way for pipelines and shippers to avoid any public interest scrutiny when Section 311 transportation is used to discriminate against LDCs serving end-users in their franchise areas. Legislation is required to correct the errors of the Commission's new approach, and to provide the public interest balancing function which the Commission is refreshing to perform.

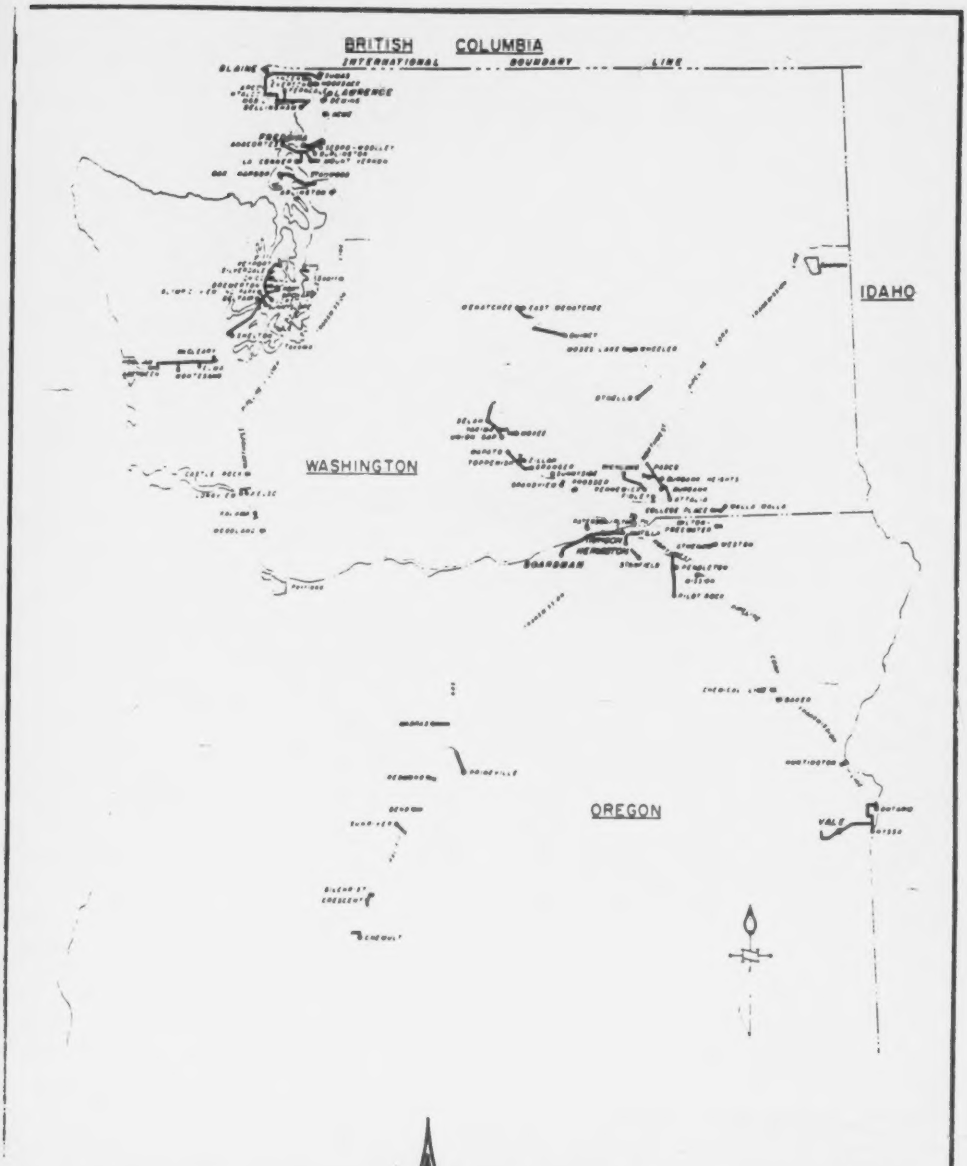
Conclusion

S. 2313 would require Federal, State, and local consideration of the full economic impact before a bypass could be sanctioned. The bill requires adequate advance notification of an interstate pipeline's intention to bypass. The bill offers a reasonable opportunity for State and local agencies to participate in the decisionmaking process by assessing the impact on all customers of the affected LDC. Most important, however, S.2313 allows a LDC to have a voice in transactions which directly affect it and its customers. S. 2313 creates a rational, integrated decisionmaking process which is in the public interest and which advances the goals of maintaining the role of local distribution companies in providing essential utility service to all customers at the lowest possible cost, and of encouraging greater competition in the natural gas industry while appropriately balancing the responsibilities of the Federal, State and local agencies in the regulatory process.

Respectfully submitted,
CASCADE NATURAL GAS CORPORATION

By
O. M. JONES
Chairman and Chief Executive Officer
Cascade Natural Gas Corporation
222 Fairview Avenue North
Seattle, Washington 98109
(206) 624-3900

EXHIBIT A


BRITISH COLUMBIA
INTERNATIONAL BOUNDARY LINE
BLAINE
LAWRENCE
IDAHO
WASHINGTON
BOARDMAN
HERMISTON
OREGON
VALE

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Eng.	N/A	Meas.	N/A

CASCADE NATURAL GAS CORPORATION
222 Fairview Ave. No. Seattle, Wash. 98109

EXHIBIT B

Cost Consequences of Bypass by Major End-Users
Cascade Natural Gas Corporation, Seattle, Washington

		--- All Other System Customers ---					
	Industrial By Bypass Candidates	Residential	Commercial Firm	Interruptible Commercial & Institutional	Remaining Industrial[1]	Subtotal All Other Sys Customers & Transport[2]	Total Company Including Transportation
1987 Therm usage	299,164,543	48,429,933	75,140,612	13,468,237	25,526,413	178,526,867	477,691,410
% of Total	63.00%	10.00%	16.00%	3.00%	5.00%	37.00%	100.00%
Revenue	$68,371,976	$26,345,974	$35,954,998	$6,180,178	$11,830,889	$83,858,039	$152,230,015
% of Total	45.00%	18.00%	24.00%	4.00%	8.00%	55.00%	100.00%
Customers	47	70,752	16,266	26	313	87,331	87,404
% of Total	0.05%	81.00%	19.00%	0.00%	0.36%	99.92%	100.00%
Potential Margin Loss[3]	$20,000,000						
Margin Loss Allocation		$5,958,217	$9,244,366	$1,656,964	$3,140,452	$20,000,000	
Gross Revenue With Margin Allocation		$33,304,191	$45,199,364	$7,837,142	$14,971,341	$103,858,039	
Average Rate With Margin Allocation		$0.68768	$0.60153	$0.58190	$0.58650	$0.58175	
Average Rate Before Margin Allocation		$0.56465	$0.47850	$0.45887	$0.46348	$0.46972	
Potential Rate Increase From Bypass		$0.12303	$0.12303	$0.12303	$0.12303	$0.11203	

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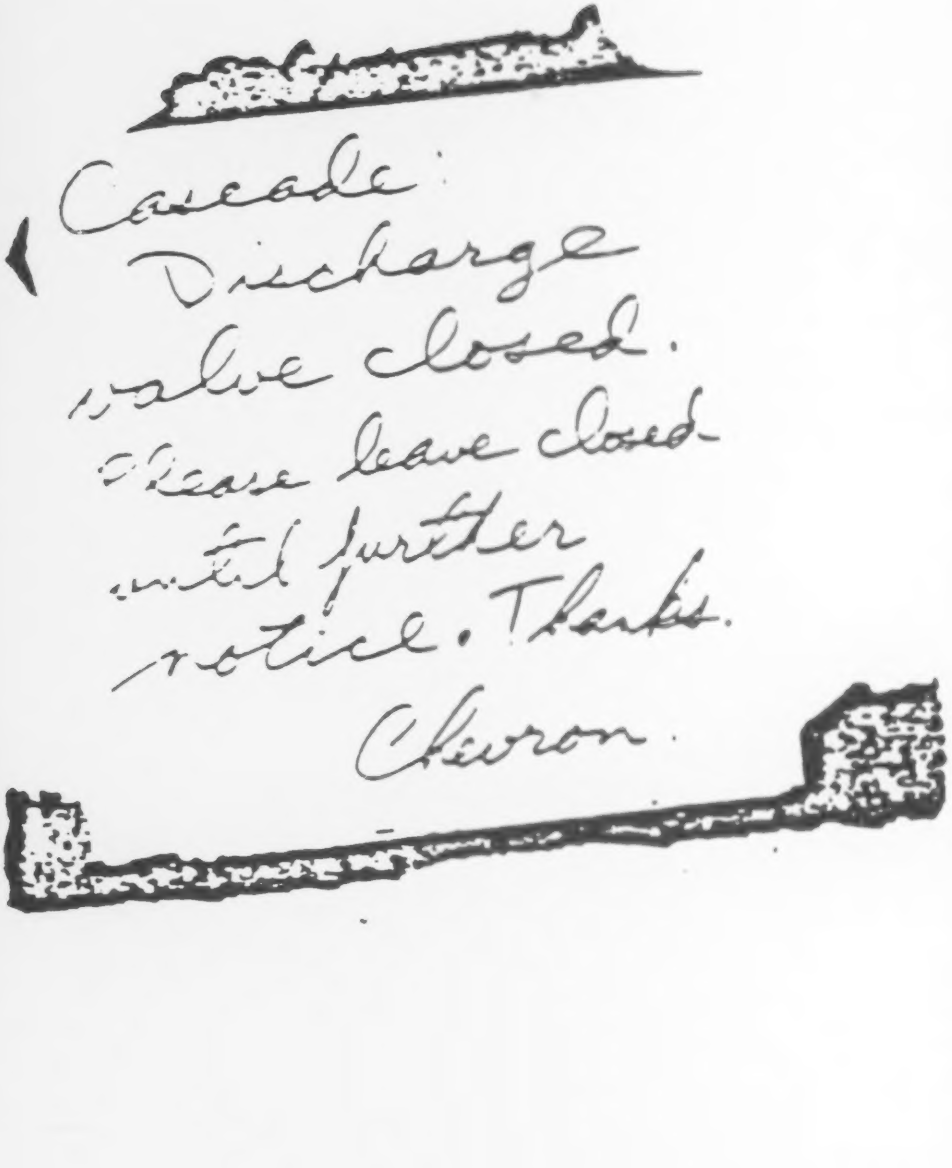
[1] The Margin Loss Allocation is based upon the proportion of each class' 1987 Revenue to the Total 1987 Revenue for the three affected classes.

[2] Transportation statistics were included in this column in order to indicate how the overall impact of the Margin Loss of 23.8% was derived.

[3] The Industrial class contains both Industrial Firm and Interruptible customers. Increases of this magnitude shown would immediately influence Cascade's ability to retain the Interruptible customers and further impact the analysis.

		--- All Other System Customers ---			
	Residential	Commercial Firm	Interruptible Commercial & Institutional	Remaining Industrial	Subtotal All Other Sys Customers & Transport
Average Monthly Usage	57	385	43,167	6,796	170
Average Annual Usage	685	4,619	518,009	81,554	2,044
Average Monthly Bill Before Bypass	$32.21	$184.20	$19,808.26	$3,149.86	$80.02
Average Monthly Bill After Bypass	$39.23	$231.56	$25,119.05	$3,985.98	$99.10
Monthly Charge	$7.02	$47.36	$5,310.78	$836.12	$19.08
Annual Charge	$84.24	$568.32	$63,729.40	$10,033.44	$229.01
Percentage Change in Monthly Bill	21.79%	25.71%	26.81%	26.54%	23.85%

EXHIBIT C



Cascade
Discharge
valve closed.
Please leave closed-
until further
notice. Thanks.
Chevron.

Senator FOWLER. Thank you very much.

STATEMENT OF HON. HOWARD M. METZENBAUM, U.S. SENATOR FROM OHIO

Senator METZENBAUM. Thank you very much, Mr. Chairman. I appreciate it very much, and I appreciate your tolerance of letting me come in very, very briefly.

I thank our chairman for presiding over this hearing today to look into the issue of natural gas bypass and specifically to examine Senate bill S. 1998 introduced by Senator Breaux, and S. 2313, a bill I introduced earlier this year.

The bypass situation arises when a large user of natural gas decides to hook up directly to an interstate pipeline and thus bypass the local utility. Although a relatively straightforward situation on the surface, there are more parties involved in the equation than just the local distribution company, the LDC, the pipeline and the end user. Namely, the others are the remaining customers on the system.

The effects of bypass, although beneficial to the one or several end users, may have just the opposite consequences for the remaining customers of the LDC. When a bypass occurs, costs are invariably shifted from the customer who bypasses the local distributor, to residential, commercial, and small industrial customers still on the system, customers who simply don't have the option to leave the system. Therefore, an end user's net gain may translate into high rates for everyone else.

By the heart of the bypass situation is the question of what role the federal and state agency should play in deciding the merits of a particular bypass. The net effect of each bypass case whether beneficial or detrimental will be felt locally.

The state public utility commissions which traditionally have responsibility for local gas distribution and are charged with the responsibility to protect the interests of all LDC customers are in the best position to gauge the effects of a proposed bypass for a majority of all the ratepayers involved.

My bill would not prohibit utility bypass, but would insure that state utility commissions play a key role in determining the merits of a bypass on a case-by-case basis. Basically it provides that FERC could not permit a bypass before the state or local commission has made a finding that the bypass, "would prejudice the present or future interests of," the other ratepayers.

In addition, bypass would not be allowed if the local distribution company is willing to provide transportation service under terms set by the state or local commission.

Historically, State and local commissions have regulated issues involving natural gas service to end users, and I believe that they continue to be in the best position to do so.

Again, Mr. Chairman, I want to commend you for the timely nature of this hearing, and I look forward to an informative discussion on the issue and solid action by this committee.

[The prepared statement of Senator Metzenbaum follows:]

OPENING STATEMENT BY SENATOR HOWARD M. METZENBAUM
CHAIRMAN
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES

There are few issues which are more controversial in the natural gas industry than the "bypass" issue which we will examine here today. We need to study this complex issue in a careful and thorough manner. I appreciate Senator Fowler's willingness to chair the hearing.

The various industry and consumer interests have starkly different viewpoints about whether or not it is in the public interest to allow large industrial gas users to bypass the local distribution companies, buying supplies directly from producers. Industrial users will tell us that they must be able to purchase the lowest cost supplies in order to survive and grow in an increasingly competitive world market. If factories can reduce costs, workers keep their jobs and new jobs are created.

Representatives of residential consumers will tell us that we must restrict bypass in some instances so that homeowners aren't left paying more of the fixed costs of the LDC when industrials leave the system to buy elsewhere. LDC's themselves will say that they made decisions to build facilities based on a predictable, regulated market--only to find a changed market today that allows customers to buy elsewhere.

Undoubtedly, the natural gas industry has undergone significant changes in recent years, moving toward a more competitive market. As this process continues, we must insure that captive customers--homeowners and small businesses--share the benefits. Millions, maybe billions of dollars are at stake. For these reasons, I believe that Congress should move cautiously with respect to any changes to the nation's natural gas policy.

I appreciate the cooperation of all the witnesses who have agreed to testify this morning.

Senator Fowler. Thank you very much.

Mr. Jerald Halvorsen, President of Interstate Natural Gas Association of America.

STATEMENT OF JERALD V. HALVORSEN, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. Halvorsen. I am Jerry Halvorsen, President of the Interstate Natural Gas Association of America or INGAA. INGAA represents the interstate natural gas pipeline industry in the United States. We also represent the major interprovincial pipelines in Canada. I have submitted a detailed statement for the record and will briefly summarize that statement.

INGAA opposes the two anti-bypass bills that are the subject of this hearing. These bills are, number one, anticompetitive. The two bills would insulate local distribution companies from market forces.

They are also unnecessary. Existing law protects the legitimate concerns of all affected parties and balances state and local jurisdiction pertaining to natural gas.

Mr. Chairman, these bills are unnecessary because the Federal Energy Regulatory Commission or FERC already has adequate jurisdiction under the Natural Gas Act of 1938 to protect the public interest.

In charging the commission with protecting consumers of interstate and natural gas, the Congress gave the commission certificate authority. Under this authority the commission determines if proposals for service are consistent with the public convenience and necessity. Proposals involving bypass necessarily are part of this process.

These bills if passed would add an unneeded layer of review to an area already subject to comprehensive federal regulation under FERC.

We agree with Senator Breaux that these two bills raise issues which need to be addressed. However, we believe that the FERC with the charge they now have from you and the Congress is an appropriate agency to address and resolve these issues.

In addition, these two bills would interfere with the balance of federal and state authorities. The Natural Gas Act granted the commission the exclusive responsibility to regulate natural gas in interstate commerce. The courts have consistently held up that grant of authority. By giving state authorities in effect veto power over these commission decisions, these bills would diminish the clear demarcation between federal and state responsibilities set forth in the Natural Gas Act.

We also believe, Mr. Chairman, that these bills may ultimately have an anticompetitive effect. It was in the spirit of competition that the FERC dramatically restructured the interstate natural gas pipeline industry through a series of orders. These orders have allowed distributors to bypass pipelines and purchase natural gas directly from any available source.

Many distributors are now purchasing low price spot market gas in lieu of more secure long-term supplies from interstate pipelines. Maintaining the bypass option provides consumers with a way to enjoy the benefits the distributors are now receiving under the commission orders.

In summary INGAA opposes any attempt to legislatively interfere with the existing NGA procedures for FERC consideration of bypass requests. Our position is not based on any desire of the interstate pipelines to bypass local distribution companies. To the contrary, Mr. Chairman, the local distribution companies are our best customers. But each natural gas consumer must have the bypass alternative available to assure adequate and reliable supplies at competitive prices.

Thank you, Mr. Chairman, for the opportunity to appear this morning, and we would be happy to try and answer any questions.

[The prepared statement of Mr. Halvorsen follows:]

TESTIMONY OF JERALD V. HALVORSEN
PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA (INGAA)
BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
REGARDING S. 1998 AND S. 2313

SEPTEMBER 29, 1988

Mr. Chairman and Members of the Subcommittee:

I am Jerald V. Halvorsen, President of the Interstate Natural Gas Association of America (INGAA). INGAA represents the interstate natural gas pipeline industry in the United States and the major interprovincial pipelines in Canada.

INGAA opposes the two anti-bypass bills that are the subject of this hearing, S. 1998 and S. 2313.[1] These bills are:

- Unnecessary – existing law protects the legitimate concerns of all affected parties and balances state and federal jurisdiction pertaining to natural gas; and
- Anti-competitive – the two bills would insulate local distribution companies from market forces.

Mr. Chairman, these bills are unnecessary because the Federal Energy Regulatory Commission (Commission) already has adequate jurisdiction to protect the public interest with respect to proposals for service, including those involving bypass, under the Natural Gas Act (NGA). In the NGA, the Congress declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with the public interest. In charging the Commission with protecting consumers of interstate natural gas, the Congress gave the Commission certificate authority to determine if proposals for service are consistent with the public convenience and necessity. Proposals involving bypass necessarily are part of this certificate process. In this regard, the Commission takes into account the benefits derived by the ultimate consumers of the gas in question. Furthermore, it weighs those benefits against any costs which may be borne by other gas consumers. For local interests with legitimate concerns about the appropriateness of a bypass request and its impact on a distributor's remaining customers, the NGA guarantees an opportunity for parties to express those concerns to the Commission. The Commission issues a certificate which may include bypass only when it has determined that doing so is in the public interest. These bills would add an extraneous layer of review to an area already subject to comprehensive federal regulation. We certainly agree with Senator Breaux and the other distinguished sponsors of these two bills that, in some instances, bypass proposals raise difficult issues which need to be addressed by a regulatory body charged with the public interest. The Commission is such an agency.

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[1] S. 1998 would require the Federal Energy Regulatory Commission (FERC) to reject a pipeline's request to provide transportation service if a state, municipality, state commission, or LDC demonstrated that the affected LDC was willing to transport gas without discrimination and at prices approved by its state commission. S. 2313 is similar, but in addition would prevent the FERC from permitting bypass when the state commission certified that the interests of the affected customers would be prejudiced.

In addition, these two bills would interfere with the balance of federal and state authorities. The NGA granted the Commission the exclusive responsibility to regulate gas in interstate commerce. The courts have invariably held that a state agency's efforts to regulate commerce must fall when they conflict with or interfere with federal authority over the same activity. By giving state authorities, in effect, veto power over these Commission decisions, these bills would diminish the clear demarcation between federal and state responsibilities set forth in the NGA. Allowing state utility commissions to act as surrogate watchdogs and to substitute their judgment for the Commission's in all bypass proposals would make it virtually impossible for the Commission to fulfill its public interest charter. Therefore, INGAA believes that existing laws adequately protect the public interest.

We also believe these bills may ultimately have an anti-competitive effect in certain instances. It was in the spirit of competition that the Commission has dramatically restructured the interstate natural gas pipeline industry through a series of orders. These orders have allowed distributors to bypass pipelines and purchase natural gas from any available source. Many distributors are now purchasing low-priced spot market gas in lieu of more secure long-term supplies. These orders have also shifted responsibility for acquiring supply from the pipelines to their customers and consumers. Maintaining the bypass option provides consumers with a way not only to enjoy the benefits the distributors are receiving under the Commission orders, but also to enhance the security of their supply.

Competition in interstate natural gas markets has increased as transportation by interstate pipelines has grown from almost nothing in 1982 to over half the gas delivered to market in 1987. This competition has helped decrease prices paid by residential consumers by 30 percent over the last four years.[2] If further decreases are to be realized, competition must not be restricted. Some distributors, however, want the benefits of competition to stop at the city-gate. They have either refused to transport or have charged unreasonably high rates. The threat of bypass is one of the few tools gas consumers can use to pressure distributors to remedy this situation. We urge the Congress to keep the bypass option open.

In summary, INGAA opposes any attempt to legislatively interfere with the existing NGA procedures for considering bypass requests. INGAA's view is not based on any desire of interstate pipelines to bypass local distribution companies. Indeed, pipelines have no stated desire to bypass distribution companies, who are our best customers. But natural gas consumers must have the bypass alternative to assure adequate and reliable supplies of natural gas at competitive prices.

Thank you, Mr. Chairman, for the opportunity to appear here today. I would be pleased to answer any questions.

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[2] *Natural Gas Monthly*, Energy Information Administration (EIA), Table 4, June 1986 and April 1988; calculations assume nominal dollars.

Senator FOWLER. Thank you, Mr. Halvorsen, for your complete statement and also for your fine summary. We are going to hold all the questions to the panel until after we go through all.

Mr. Bush, once again I am joined by one of my colleagues from Oklahoma, the distinguished Senator, Mr. Nickles.

Senator NICKLES. And I will yield for whatever statement he might make.

Thank you very much. I do have a statement, somewhat lengthy statement, and I will have it—maybe it has already been inserted in the record, and I apologize for being a few minutes late. I also apologize for the fact that I am going to leave. We have a caucus. I don't know if the Democrats are having one, but we are having one at 10:15 to decide what to do on several of the items that are still on the legislative agenda. So, this is unfortunate.

Senator FOWLER. We appreciate whenever your collective heads are put together.

Senator NICKLES. Sometimes it is necessary for collective efforts to try and get us out of town.

Mr. Chairman, a couple of comments concerning this legislation. Now, I have looked at the legislation. I have some problems with this legislation, a couple of problems, I guess, procedurally.

One, I think it is too late in the legislative year to pass this legislation. Certainly there is no problem with the hearing, but if there is a serious effort, and I didn't hear Senator Cranston's opening remarks, but I will state for your information that it is this senator's thoughts that it is too late in the session to try and see this type of legislation become law, and I will take strong efforts to make sure that it does not become law this session.

We have the opportunity if so desired to consider it next year, and I will be happy to seriously consider it, but I do not think that we should be making this type of change dealing with bypass and I am talking about the substance of the bill. I think it would be detrimental, and I say the bill—I guess there are two bills that have been introduced.

Looking at them I think they would significantly retard competition in natural gas. That would be a mistake and my state is, I am sure that you are well aware, of its big natural gas, and I do not want to do anything that would retard this industry.

I think there is great potential in natural gas industry, and I do not want to see Congress mess it up. And I think this legislation, the legislation proposed both by Senator Cranston and by Senator Breaux, would have a detrimental impact. And if the legislation or the testimony today proves me wrong, and I am certainly open to hear comments from all sides on the issue, then my staff and I will be reviewing those comments.

I will be happy to work with interested parties to see what we could do. But, again, I think for this year time does not allow us to give this serious issue significant consideration to enact legislation. And so I wanted the chairman to know where I am coming from.

Senator FOWLER. I appreciate that, and you can have my assurance that there is not for many reasons, but certainly for the reasons that you outlined, there will be no attempt to legislate this issue this year. This is an initial public airing of various viewpoints made necessary more than anything else by the number of legislative remedies that are being proposed.

Senator Nickles. I appreciate that. I really did not know, and sometimes, as I know the chairman is aware of, sometimes in late sessions we have two or three different things that people try and have become law.

Senator Fowler. I do have two or three of those, but this is not one of them. [Laughter.]

Senator Nickles. Thank you, Mr. Chairman.

Senator Fowler. Thank you. We thank you for your patience, Mr. Bush.

STATEMENT OF NICHOLAS J. BUSH, PRESIDENT, NATURAL GAS SUPPLY ASSOCIATION

Mr. Bush. I am Nicholas Bush, President of the Natural Gas Supply Association. NGSA is a national organization comprised of independent and in grade domestic companies that explore for, develop, and market natural gas.

Today I am also testifying on behalf of the Independent Petroleum Association of America, IPAA, and the Independent Petroleum Association of the Mountain States, IPAMS. Together the members of NGSA, IPAA, and IPAMS provide and market virtually all of the nation's natural gas production.

Mr. Chairman, I will summarize with your assurance that my full statement will be entered into the record.

Senator Fowler. You have that assurance.

Mr. Bush. Mr. Chairman, producers oppose S. 1998 and S. 2313. However, we do not appear this morning as advocates of the bypass of local distribution systems. There are, however, strong reasons to preserve the bypass option.

Congress and the Federal Energy Regulatory Commission have moved the natural gas industry toward a market-oriented competitive environment. As a result, consumers have reaped significant benefits.

We are struggling now to establish a working nationwide open access interstate transportation system for natural gas. The benefits in achieving such a system are increasingly apparent.

Natural gas is a domestic resource with a strong potential to displace a significant amount of imported oil. Vice President Bush and Governor Dukakis have indicated their beliefs that increased gas production and sales are important national energy priorities. We would point out, though, that passage of either of these bills would likely be serious inhibiters to increased natural gas use.

Concern is expressed by some, and it is sincere, and I am sure it will be heard again this morning as it has been mentioned already, that residential gas consumers are harmed by bypass. There is only one way to ensure that homeowners get the most supply at the lowest possible price, and that is to encourage a healthy competitive gas market.

Trying to coerce some gas consumers to suffer uncompetitive rates is wrong and, as importantly, futile. Industrial gas customers have demonstrated their clear intention and their ability to seek out the lowest price fuel. Doing so is no longer an option. In today's highly competitive worldwide markets, it is a necessity. To ignore this is an effort to protect a monopoly position of an LDC is to invite the irrevocable loss of significant gas sales.

I ought to note, Senator, just in passing that the opposition of LDS's to bypass is an opposition to bypass for their customers and for pipelines. They do not oppose it for themselves.

Just recently Atlantic Gas Light built a pipeline bypassing Sonat to obtain cheaper supplies from Tennessee. Just recently in a letter to the Federal Energy Regulatory Commission that I am sure Ms. Cook can speak to more directly, Entex, a subsidiary of Arkla in the Southwest, complained bitterly about a united rate increase saying that if it could bypass and if it did bypass United, it could pay for that option in merely 3 years.

So, the option to bypass to obtain cheaper fuels is not just restricted to some particular group of consumers. In fact, it is noted and used often by LDC's.

It is important to realize as well that in regions where natural gas would significantly displace imported oil and enhance efforts to improve air quality, new interstate pipeline systems will be constructed only if large volume customers participate in the market, and such customers participate only when they believe competitive rates are available.

Another concern expressed by some is that bypass is a states' rights issue and that FERC as a federal entity should be precluded from addressing it. That is simply not true. Our federal system must encourage and protect flourishing interstate commerce.

The importance of competition within the natural gas industry and the importance of improving regulatory or legislative impediments to all consumers benefitting from a truly open access transportation and distribution system are the reasons that the issue is before this committee and not just before 50 State legislatures.

States and in particular state public utility commissioners have a crucial role of determining whether or not consumers will realize the benefits of increased competition in the natural gas industry, and they have that right and that duty now.

But, disappointingly, the record of the states is very mixed. In states where buyers have ready access to many sources of natural gas, competitive rates are usually fashioned. In some states such as Virginia, aggressive and enlightened state commissioners have fashioned rates for LDC's that are highly competitive and that make bypass a very unlikely option.

However, in still too many states LDC gas transportation rates are unchallenged by competition and, as a result, they are significant and inexplicably increasing expenses for gas users. Some transportation rates, in fact, have exceeded at times the spot market cost of gas and actually in a few instances have actually exceeded the average national wellhead price for gas.

The argument is made that the shortsightedness of any particular state commission should not serve as a basis for federal involvement. But the point is that opponents of this legislation are not advocating mandating bypass. Rather, they argue that consumers should not be denied the benefits of competition from a viable national gas transportation system.

We would note, Senator, that states' right in our opinion is no more justification for preserving monopoly position and design consumer rights than it is to deny civil rights. Thank you.

[The prepared statement of Mr. Bush follows:]

PROTECTING THE LDC MONOPOLY BY PROHIBITING COMPETITIVE BYPASS:
THE U.S. GAS PRODUCER'S PERSPECTIVE

TESTIMONY
OF
NICHOLAS J. BUSH
PRESIDENT
NATURAL GAS SUPPLY ASSOCIATION (NGSA)
AND ON BEHALF OF
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA (IPAA)
AND
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES (IPAMS)

BEFORE THE
SUBCOMMITTEE ON ENERGY REGULATION & CONSERVATION
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

SEPTEMBER 29, 1988

SUMMARY OF TESTIMONY OF THE NATURAL GAS SUPPLY ASSOCIATION

- NGSA supports a flourishing competitive market for natural gas. A strong market for gas will present consumers with a number of supply options and will generate competitive forces which should provide consumers with fair prices and supply security.
- Congress re-introduced competition to the wellhead market under the NGPA. FERC is seeking to assure that transportation of natural gas in the interstate market occurs on terms of equal access for all potential shippers through such regulatory initiatives as Order 436 (500). It is essential that local distribution companies share in the responsibility for providing competitive priced, non-discriminatory transportation services.
- The option which exists under current law for purchasers of natural gas to buy directly from interstate pipelines provides an incentive to local distribution companies to make more flexible and reasonably priced transportation available to all shippers.
- Few natural gas consumers want to become pipeline companies--the option of threatening bypass is merely a means of assuring that the distribution companies do not take unfair advantage of consumers. Consequently, there may be a need to reassess the role of the LDC service obligation and its relationship with the PUC.
- Anti-bypass legislation is not an appropriate subject for Federal legislation and the nation's natural gas producing industry is united in its opposition to legislation such as S. 1998 and S. 2313

THIS TESTIMONY IS ON BEHALF OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA (I-P-A-A), THE INDEPENDENT PETROLEUM ASSOCIATION OF THE MOUNTAIN STATES (I-P-A-M-S) AND THE NATURAL GAS SUPPLY ASSOCIATION (N-G-S-A). N-G-S-A IS A NATIONAL ORGANIZATION COMPRISED OF INDEPENDENT AND INTEGRATED DOMESTIC COMPANIES WHICH EXPLORE FOR, DEVELOP AND MARKET NATURAL GAS. TOGETHER THE MEMBERS OF N-G-S-A, I-P-A-A, AND I-P-A-M-S PROVIDE AND MARKET VIRTUALLY ALL OF THE NATION'S NATURAL GAS PRODUCTION.

MR. CHAIRMAN, WE APPRECIATE THIS OPPORTUNITY TO COMMENT ON THE PENDING BILLS, S. 1998 AND S. 2313. I WILL FOCUS MY TESTIMONY, IN PARTICULAR, ON THE POTENTIAL IMPACT OF THIS ANTI-COMPETITIVE LEGISLATION ON DOMESTIC GAS PRODUCERS AND UNITED STATES GAS MARKETS.

CONGRESS, IN THE NATURAL GAS POLICY ACT OF 1978 (N-G-P-A), CHOSE TO MOVE TOWARD DEREGULATION OF THE NATURAL GAS INDUSTRY IN AN EFFORT TO STIMULATE COMPETITION, INCREASE NATURAL GAS SUPPLIES AND BENEFIT CONSUMERS. MOREOVER, THE FEDERAL ENERGY REGULATORY COMMISSION (F-E-R-C) HAS MADE SIGNIFICANT STEPS TO CREATE AN ENVIRONMENT OF COMPETITION IN ALL GAS MARKETS. INDEED, ORDER 436 (500) CAN BE SEEN AS F-E-R-C's ATTEMPT TO PROPEL PIPELINES TO SEEK NEW DOWNSTREAM MARKETS. THE F-E-R-C, IN NUMEROUS RECENT

REGULATORY DECISIONS HAS REINFORCED THAT CONGRESSIONAL EFFORT AND, IN PARTICULAR, HAS IDENTIFIED COMPETITIVE OPEN-ACCESS TO ALL NATURAL GAS SUPPLIES AS THE MEANS OF ASSURING THAT CONSUMERS BENEFIT MOST. THE WISDOM OF THOSE PRO-COMPETITIVE POLICY DECISIONS IS DEMONSTRATED EACH DAY IN THE MARKETPLACE.

THE INTERSTATE PIPELINE SYSTEM IS ENTERING A MAJOR NEW PHASE IN THE EVOLUTION OF THESE POLICIES. THIS IS BECAUSE ORDER 436 (500) GIVES PIPELINE CUSTOMERS POTENTIALLY GREATER ACCESS TO SPOT MARKET GAS OR THE ABILITY TO CONTRACT DIRECTLY FOR GAS WITH PRODUCERS. AS A CONSEQUENCE OF COMPETITION ENTERING INTO THE NATURAL GAS PIPELINE INDUSTRY, A NATIONWIDE TRANSPORTATION GRID IS STRUGGLING TO BE ESTABLISHED. IF CONSUMERS OF NATURAL GAS ARE TO BENEFIT FROM SUCH A SYSTEM IT IS ESSENTIAL FOR L-D-Cs TO PLAY A COMPETITIVE ROLE.

MANY L-D-Cs HAVE BENEFITED FROM THE INTRODUCTION OF COMPETITION BY THE F-E-R-C, CHOSING TO ADD ONE OR MORE ADDITIONAL PIPELINE SOURCES OF SUPPLY AND ENTERING INTO THE SPOT MARKET. THEY HAVE PLAINLY DEMONSTRATED THE BENEFITS OF COMPETITION, AND THEIR CUSTOMERS HAVE BEEN THE BENEFICIARIES OF THESE ACTIONS.

BUT WHILE MANY L-D-Cs CHOOSE TO HAVE COMPETITIVE SOURCING WHEN IT COMES TO PIPELINES, THEY WOULD DENY LARGE INDUSTRIAL CUSTOMERS ACCESS TO COMPETITIVE TRANSPORTATION AND SALES SERVICES. IT IS THIS DICHOTOMY WHICH SMACKS OF MONOPOLISTIC ABUSE AND ALARMS INDUSTRIAL GAS CONSUMERS.

A STRONG INDUCEMENT FOR L-D-Cs TO PROVIDE SERVICES AT COMPETITIVE PRICES IS CONCERN THAT THE USERS MAY EXERCISE THE OPTION TO BYPASS AN UNCOMPETITIVE L-D-C BY SEEKING F-E-R-C APPROVAL TO PURCHASE DIRECTLY FROM A PRODUCER OR AN INTERSTATE PIPELINE AT MORE FAVORABLE RATES. THE CONGRESS SHOULD NOT REMOVE OR DILUTE THIS INDUCEMENT.

THE UNDERLYING ISSUE REGARDING THE OPTION TO BYPASS IS WHETHER AMERICAN CONSUMERS AND THEIR STATE PUBLIC UTILITY COMMISSION REPRESENTATIVES WILL INSIST THAT ALL L-D-Cs OPERATE THEIR BUSINESSES AND DESIGN THEIR RATES SO AS TO SERVE END-USERS AT COMPETITIVE PRICES. A PRIMARY QUESTION IN THIS CONTEXT IS WHAT WILL BEST PROTECT THE HOMEOWNER AND OTHER SO-CALLED "CAPTIVE" CONSUMERS OF NATURAL GAS?

NATURAL GAS PRODUCERS BELIEVE THAT THE ANSWER TO THIS QUESTION IS STRAIGHTFORWARD: A HEALTHY, GROWING GAS MARKET. BUSINESS AND REGULATORY DECISIONS WHICH MAINTAIN CURRENT LEVELS OF GAS DEMAND AND WHICH FOSTER NEW DEMAND FOR GAS WILL PROTECT CAPTIVE CONSUMERS. DECISIONS WHICH SHRINK THE SIZE OF THE GAS MARKET INEVITABLY WILL HAVE AN ADVERSE EFFECT ON CAPTIVE CONSUMERS WHO WILL BE FORCED TO PICK-UP AN INCREASED SHARE OF ALREADY SWOLLEN FIXED COSTS WHEN UTILITY SALES VOLUMES DECLINE. FOR THIS SUBCOMMITTEE'S REVIEW AND CONSIDERATION, WE HAVE ATTACHED AN EXCELLENT REVIEW OF THE BYPASS ISSUE.

THE D.C. CIRCUIT COURT OF APPEALS IN THE A-G-D DECISION SAID IT VERY WELL: "IF STATES CHOOSE TO REQUIRE L-D-Cs TO CONTINUE

SERVICE TO NON-PAYING CUSTOMERS, THOSE STATES MUST ADDRESS THE CONSEQUENCES. THEY CAN EXTRACT THE COST FROM PRICE-INELASTIC CUSTOMERS, PRIMARILY THE SOLVENT RESIDENTIAL CONSUMERS; THEY CAN SEEK TO EXTRACT THE COST FROM INDUSTRIAL CUSTOMERS, AT THE PERIL OF DRIVING THEM OFF THE SYSTEM; THEY CAN FUND THE EXPENSE OUT OF TAX REVENUE; THEY CAN USE THEIR POWER ... TO THWART THE POSSIBLE BYPASS, ACCEPTING THE ECONOMIC CONSEQUENCE THAT THEIR INDUSTRIAL GAS USERS MAY BE UNABLE TO COMPETE WITH FIRMS IN OTHER STATES. ALL OF THESE CHOICES MAY INVOLVE SOME PAIN -- LIKE ALL TRUE CHOICES. BUT THAT HARDLY REQUIRES THE COMMISSION TO ABANDON ITS EFFORT, REQUIRED UNDER THE NGA TO FACILITATE THE FLOW OF COMPETITIVELY-PRICED GAS INTO THE HANDS OF GAS CONSUMERS EVERYWHERE." (ASSOCIATED GAS DISTRIBUTORS V. F.E.R.C., 824 F.2d 981, 1038 (D.C. CIR. 1987).)

IN NON-MONOPOLY LOCAL DISTRIBUTION MARKETS SUCH AS THE TEXAS-LOUISIANA GULF COAST REGION WHERE SUPPLIES ARE READILY AVAILABLE, MAJOR NATURAL GAS CONSUMERS TYPICALLY HAVE ACCESS TO SEVERAL SOURCES OF NATURAL GAS AND COMPETITION PROVIDES THE INCENTIVE FOR L-D-Cs TO PRICE THEIR SERVICES AS LOW AS POSSIBLE. IN OTHER AREAS, SUCH AS THE NORTHEAST, THE NORTHWEST, CALIFORNIA, AND THE UPPER MIDWEST, MANY L-D-Cs DON'T HAVE MUCH COMPETITION AND CHARGES TO CONSUMERS IN SOME INSTANCES ARE MEASURED IN MULTIPLES OF THE ACTUAL COST OF SERVICE.

IN STATES SUCH AS MICHIGAN, WASHINGTON, CALIFORNIA, NORTH CAROLINA, AND SIMILAR AREAS, L-D-C GAS TRANSPORTATION RATES ARE A SIGNIFICANT, AND INEXPLICABLY INCREASING EXPENSE FOR GAS USERS.

L-D-C RATES IN NORTH CAROLINA, MICHIGAN AND CALIFORNIA, FOR EXAMPLE, CAN EXCEED $1.20 PER MCF FOR TRANSPORTATION ALONE. SOME TRANSPORTATION RATES RANGE AS HIGH AS $2.00 PER MCF IN WASHINGTON STATE -- HIGHER THAN THE SPOT MARKET COST OF THE GAS ITSELF, AND HIGHER THAN THE AVERAGE NATIONAL WELLHEAD PRICE FOR ALL GAS.

IN CONTRAST, THE INTERRUPTIBLE TRANSPORTATION CHARGE FOR NATURAL GAS FROM KATY, TEXAS TO NEW YORK CITY, A DISTANCE OF ABOUT SEVENTEEN HUNDRED MILES, COSTS ONLY 57 TO 61 CENTS PER MCF ON THE TRANSCO GAS PIPELINE.

IN SEVERAL STATES WHERE COMPETITION EXISTS OR WHERE STATE PUBLIC UTILITY COMMISSIONS ARE MORE AGGRESSIVE IN DEMANDING COMPETITIVE RATES, SUCH AS TEXAS AND VIRGINIA, THE TRANSPORTATION SERVICES PROVIDED BY L-D-Cs RUN AS LOW AS 18 CENTS PER MCF. IN THESE STATES CONSUMERS ARE WELL SERVED AND THERE IS LITTLE INCENTIVE FOR CUSTOMERS TO BYPASS THE L-D-C.

IN FACT, THE HYSTERIA OVER A HANDFUL OF ACTIVE BYPASS SITUATIONS HAS MASKED THE REAL STORY OF COMPETITIVE GAS MARKETS. THIS QUIET STORY IS THE ACTUAL DECLINE OF INTEREST IN BYPASS WHICH IS OCCURRING IN STATES WHICH HAVE REFORMED THEIR L-D-C TRANSPORTATION RATES. IT MAY NOT MAKE HEADLINES WHEN CALM DESCENDS IN VIRGINIA AND THE HUE AND CRY FOR BYPASS SUBSIDES. BUT CONGRESS MUST WEIGH THE SUCCESS OF RATE REFORM AT THE STATE LEVEL BEFORE EMBARKING ON BROAD PROTECTIONIST LEGISLATION.

ATTACHED TO MY PRESENTATION IS AN INFORMAL SURVEY OF L-D-C INTERRUPTIBLE TRANSPORTATION RATES FOR OVER 20 STATES. WHILE

THESE RATES REPRESENT MANY DIFFERENT RATE-MAKING METHODOLOGIES AND SPECIAL RATES ARE IN EFFECT IN A NUMBER OF STATES, THERE IS CLEARLY A VAST DIFFERENTIAL BETWEEN THE LOWEST AND THE HIGHEST RATES.

RESIDENTIAL SALES REPRESENT ONLY A QUARTER OF ALL GAS SALES. RESIDENTIAL CONSUMERS NEITHER DRIVE THE MARKET NOR ARE CAPABLE OF PAYING ALL UTILITY FIXED COSTS. THE PRIMARY FACTOR BEHIND THE NATURAL GAS MARKET IS THE FUEL SWITCHABLE INDUSTRIAL USER.

THE SHAREHOLDERS AND THE EMPLOYEES OF THESE LARGE CONSUMERS OF NATURAL GAS HAVE LONG MEMORIES, BACK TO THE TIME WHEN PRIOR REGULATORY POLICIES CAUSED UNNECESSARY GAS INTERRUPTIONS IN THE MID-1970's. MANY OF THESE WERE FORCED TO SHUT DOWN. IN RESPONSE, END-USERS HAVE SPENT NEARLY A BILLION DOLLARS SINCE 1973 TO INSTALL FUEL-SWITCHING CAPABILITY. WE HAVE BEEN TOLD BY THE MANUFACTURERS OF STEAM BOILERS THAT 85% OF THE BOILERS SOLD IN THE PAST TEN YEARS ARE DUAL-FUEL CAPABLE AND AROUND $90 MILLION A YEAR IS STILL SPENT BY INDUSTRIALS TO INSTALL DUAL-FUEL CAPABILITY.

INDUSTRIAL GAS CONSUMERS HAVE DEMONSTRATED THE INTENTION AND THE ABILITY TO SEEK OUT THE LOWEST PRICED ENERGY SOURCES. EARLIER CONCERNS WITH SECURITY OF SUPPLY ARE NOW MATCHED BY PRESSURE FOR EFFICIENCY AND COST CONTAINMENT.

IT IS CRITICAL FOR STATE AND FEDERAL LEGISLATORS AND REGULATORS TO RECOGNIZE THAT IF THE INDUSTRIAL SEGMENT IS DRIVEN

AWAY FROM CONSUMPTION OF NATURAL GAS, CAPTIVE CONSUMERS WILL BE LEFT WITH ALL OF THE COSTS OF AMORTIZING THE LOCAL AND INTERSTATE TRANSMISSION INVESTMENT. IF BYPASS OF ANTI-COMPETITIVE L-D-Cs IS FORBIDDEN BY THE FEDERAL GOVERNMENT, THERE WILL BE AN INCREASING LEVEL OF FUEL SWITCHING AND SIGNIFICANT LOAD LOSS AMONG LARGE GAS CONSUMERS.

WHEN OIL AND OTHER ENERGY PRICES BEGAN TO PLUMMET, PRODUCERS WERE THE FIRST TO RECEIVE THE MARKET SIGNAL. THE AVERAGE WELLHEAD PRICE OF GAS FELL FROM $2.66 PER MCF IN 1984 TO $1.71 PER MCF IN 1987. THE SPOT MARKET PRICE OF GAS IN THE GULF OF MEXICO REGION, ONE OF THE BEST INDICATORS OF THE IMPACT OF THE COMPETITION FOR INDUSTRIAL GAS SALES, DROPPED FROM $3.10 PER MCF IN JUNE, 1984 TO $1.30 IN JUNE, 1987. TODAY, THE AVERAGE SPOT MARKET PRICE FOR NATURAL GAS IS SLIGHTLY ABOVE THE LOW $1.30 PRICE REACHED LATE IN THE SUMMER OF 1987.

AS A RESULT, BETWEEN 1985 AND 1987, NATURAL GAS PRODUCERS HAVE REALIZED A $43 BILLION CUMULATIVE REVENUE DECLINE. THIS REVENUE DECLINE FOR THREE YEARS FAR EXCEEDS THE TOTAL PRODUCER REVENUES OF $31 BILLION IN 1987. THE TIME HAS COME TO DEMAND SACRIFICES AND COMMON SENSE IN OTHER SEGMENTS OF THE NATURAL GAS INDUSTRY IN ORDER TO ASSURE THAT ALL CONSUMERS ENJOY THE BENEFITS OF CONTINUED NATURAL GAS USE. AS THE COURT IN A-G-D SAID, IF AN L-D-C IS "INEFFICIENT" OR ENGAGES IN "PRICE DISCRIMINATION," IT "DESERVES TO LOSE." (824 F.2d 1034).

PROHIBITING BYPASS WILL ONLY SERVE TO SUBSTANTIALLY AND IMMEDIATELY INCREASE THE COST OF SERVICE TO CAPTIVE CUSTOMERS.

THE ONLY BENEFICIARIES OF ANTI-BYPASS LEGISLATION ARE LOCAL DISTRIBUTION COMPANIES THAT RECEIVE A VIRTUALLY GUARANTEED RATE OF RETURN REGARDLESS OF THE BURDEN ON CUSTOMERS.

NUMEROUS COURT CASES AND ADMINISTRATIVE RULINGS BY REGULATORY AGENCIES DEMONSTRATE THE BENEFITS OF BYPASS AND THE COMPROMISES THAT HAVE BEEN REACHED BETWEEN INDUSTRIAL USERS, L-D-Cs AND P-U-Cs.

FOR EXAMPLE, IN THE COLUMBIA NITROGEN CORPORATION MATTER FILED AT THE F-E-R-C,[*] ATLANTA GAS LIGHT COMPANY ARGUED THAT THE LOAD LOSS ENGENDERED BY THE PROPOSED BYPASS WOULD INCREASE THE OVERALL GAS COSTS TO INDUSTRIAL AND SMALL COMMERCIAL CUSTOMERS. BEFORE THE COMMISSION DECIDED THE CASE, THE GEORGIA PUBLIC SERVICE COMMISSION INSTITUTED RULES ALLOWING ATLANTA GAS TO OFFER BOTH CONTRACT CARRIAGE SERVICE AND MARKET SENSITIVE RATES TO INDUSTRIAL END-USERS. AS A CONSEQUENCE, COLUMBIA NITROGEN'S BYPASS PROPOSAL WAS WITHDRAWN.

ANOTHER SIGNIFICANT CASE ON THE BYPASS ISSUE TO DATE, IN OUR OWN BACKYARD, IS THE MAY 1987 SETTLEMENT OF AN ANTITRUST SUIT, DISTRICT OF COLUMBIA HOSPITAL ENERGY COOPERATIVE INC., ET AL. V. WASHINGTON GAS LIGHT CO. THE PLAINTIFFS IN THE SUIT WERE A GROUP OF WASHINGTON, D.C. HOSPITALS WHO HAD ARRANGED FOR DIRECT DISCOUNTED SPOT PURCHASES OF GAS FROM YANKEE RESOURCES, INC., AN INDEPENDENT SUPPLIER BASED IN OHIO. THE HOSPITALS SOUGHT TO HAVE

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[*] See FERC Docket No. CP85-529.

THE LOCAL TRANSPORTATION OF THAT GAS CARRIED OUT BY THEIR L-D-C, WASHINGTON GAS LIGHT CO. (W-G-L). WHEN W-G-L REFUSED TO PERFORM THE CONTRACT CARRIAGE SERVICE REQUESTED, THE HOSPITALS SUED, ALLEGING THAT W-G-L WAS IN VIOLATION OF ANTITRUST LAWS. IN PARTICULAR, THEY ALLEGED THAT BY REFUSING TO PROVIDE DISTRIBUTION SERVICES, W-G-L WAS EFFECTIVELY EXTENDING A FRANCHISED MONOPOLY IN THE TRANSMISSION AND DISTRIBUTION OF GAS INTO AN UNSANCTIONED MONOPOLY IN THE PURCHASE AND SALE OF GAS. THE HOSPITALS SOUGHT, AMONG OTHER THINGS, A FINDING THAT W-G-L WAS ABUSING AN "ESSENTIAL FACILITY" AND A DIRECTIVE REQUIRING W-G-L TO FILE A TARIFF FOR CONTRACT CARRIAGE SERVICE. WHETHER THEY ULTIMATELY WOULD HAVE SOUGHT COMPLETE BYPASS OF W-G-L's SYSTEM IS NOT KNOWN. IN ANY EVENT, UNDER THE TERMS OF THE SETTLEMENT, W-G-L AGREED TO SEEK REGULATORY APPROVAL FROM THE D.C. PUBLIC SERVICE COMMISSION TO CARRY OUT CONTRACT CARRIAGE SERVICE FOR GAS CUSTOMERS WITHIN THE DISTRICT OF COLUMBIA. W-G-L FILED ITS CONTRACT CARRIAGE TARIFF IN JUNE, 1987.

THE ABOVE CASES ILLUSTRATE THAT MARKET ENTRY, OR THE THREAT OF COMPETITION, DISCIPLINE REGULATED GAS DISTRIBUTION MARKETS IN SOCIALLY PRODUCTIVE WAYS. IN THE FINAL RESULT, IT IS CONSUMERS WHO WILL BENEFIT FROM THESE DECISIONS. ACCORDINGLY, BYPASS AND ITS THREAT CAN INCREASE THE PRESSURE ON LOCAL UTILITIES TO HOLD DOWN THEIR COSTS, RATIONALIZE THEIR RATE STRUCTURES, AND IMPROVE THE RANGE AND QUALITY OF THEIR SERVICE OBLIGATIONS.

IN SUMMARY, AMERICA'S L-D-Cs SHOULD NOT BE AN IMPEDIMENT TO LOWER ENERGY PRICES. MANY DOMESTIC INDUSTRIES DESPERATELY NEED

COMPETITIVE ENERGY PRICES IN ORDER TO COMPETE NOT ONLY IN A NATIONAL ECONOMY, BUT ALSO IN A WORLD MARKET.

ANTI-BYPASS LEGISLATION WOULD BE LITTLE MORE THAN A SHIELD FOR MAJOR DISTRIBUTION UTILITIES AND THEIR SHAREHOLDERS FROM THE COMPETITIVE PRESSURES OF TODAY'S GAS MARKETS UNDER THE GUISE OF CONSUMER PROTECTION.

FEDERAL LEGISLATION PROHIBITING L-D-C BYPASS IS ANTI-COMPETITIVE AND ANTI-CONSUMER. SUCH LEGISLATION CERTAINLY IS NOT NECESSARY SINCE COMPREHENSIVE REGULATIONS GOVERNING THE PROCEDURES FOR BYPASS ARE MAINTAINED BY THE F-E-R-C WHICH HAS COMPLETE AUTHORITY TO PROHIBIT BYPASS IN APPROPRIATE CASES.

INCREASED COMPETITION IN THE NATURAL GAS INDUSTRY AT ALL LEVELS IS BENEFICIAL FOR CONSUMERS AND PROMOTES A HEALTHY DOMESTIC ECONOMY. PROHIBITING BYPASS FOILS THE EFFORT TO ACHIEVE SUCH BENEFITS. WE ENCOURAGE YOU TO OPPOSE S. 1998 AND S. 2313 AND OTHER LEGISLATIVE EFFORTS TO RESTRICT COMPETITION IN THE NATURAL GAS INDUSTRY.

THANK YOU FOR THIS OPPORTUNITY TO PRESENT THE VIEWS OF THE NATURAL GAS SUPPLY ASSOCIATION, THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, AND THE INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES. I WOULD BE PLEASED TO ANSWER ANY QUESTIONS WHICH YOU MAY HAVE.

SPOT SURVEY OF INTERRUPTIBLE GAS TRANSPORTATION RATES*

Alabama	Mobile Gas Service	.17/Mcf
Arkansas	ARKLA	.35 to $1.00/Mcf
Georgia	Atlanta Gas Light	.50/Mcf
Idaho		.20 to $1.10/Mcf
Illinois	Peoples Gas	.83/Mcf
	Cilco	.70/Mcf
	NIGAS	.50/Mcf
Indiana	Indiana Gas	$1.03/Mcf
	NIPSCO	.60/Mcf
Iowa	Iowa-Illinois	.40/Mcf
	Midwest Gas	.095/Mcf
	North Central	.20/Mcf
Maryland	Baltimore Gas & Elec.	.51/Mcf
Michigan	MichCon	.71/Mcf
		.30.Mcf (coal displ)
	Consumers Power	$1.90/Mcf
Minnesota	Minnegasco	.21/Mcf
Missouri	Union Electric	.78/Mcf
New York	Niagra Mohawk	.66/Mcf
North Carolina	N.C. Natural Gas	.65/Mcf (average)
	Public Service of NC	.75/Mcf (Summer)
		.57/Mcf (Winter)
Ohio	Columbia	.25 to .50/Mcf
	Cincinnati Gas & Elec.	.30 to .50/Mcf
Oregon		.30 to $1.80/Mcf
Pennsylvania	Penn Fuel	.83/Mcf
	UGI	.69/Mcf (average)
	Penn and Southern	.50/Mcf
	People's Gas	$1.50/Mcf Small Rate Payer
		.81/Mcf Large Rate Payer
	Equitable Gas	.85/Mcf
	Columbia Gas	.50/Mcf
Rhode Island		.10 to .85/Mcf

South Carolina	S.C. Pipeline	$1.06/Mcf
Tennessee	Nashville Gas	$1.00/Mcf
	Memphis Gas, Light & Water	.23 to .40/Mcf
Virginia	Commonwealth	.18/Mcf
Washington	N.W. Natural Gas	.70/Mcf .13/Mcf (one customer variable cost rate)
	Washington Water Power	$1.00/Mcf
	Cascade Natural Gas	.40/Mcf + some firm .60/Mcf, no minimum, no firm
	Washington Natural Gas	.20/Mcf minimum -- declining block rate
West Virginia	Equitable	.62 to .81/Mcf
	Hope Gas	$1.32/Mcf

*This survey was conducted to find a general range of rates in various states. A more accurate survey would have to take into account varying rate methodologies, added charges, volumetric rates, and rate negotiation allowed in some states. In general, however, this survey does indicate the wide disparity between rates for the same essential service. (Rates and ranges of rates for specific gas distribution companies have been given where available. In some states, only a range of rates is given.)

(Phone Survey Conducted 5/23/88 and 9/27/88.)

HOW NATURAL IS MONOPOLY?

The Case of Bypass in Natural Gas Distribution Markets

by

Harry G. Broadman

and

Joseph P. Kalt

December 1987

[TO BE PUBLISHED IN THE YALE JOURNAL ON REGULATION]

Affiliations and Acknowledgements

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This research was supported by Harvard University's Energy and Environmental Policy Center and by Resources for the Future. The views expressed here are the authors' alone and should not be attributed to their respective institutions, nor do these views reflect any exercise of official legislative or regulatory responsibility.

Abstract

It has been a long-held tenet that markets characterized as "natural monopolies", especially public utility markets, should be subject to not only price, or rate, regulation, but also entry regulation. Within the past decade, however, as dissatisfaction with much of the nation's regulatory system has mounted, the rationale for and indeed the practice of protecting utilities from competitors has come increasingly under attack. Numerous court cases and administrative rulings by regulatory agencies have pointed to the benefits of allowing users of a utility's services to "bypass" the utility and instead transact for these services with either new entrants or incumbent members of the industry "upstream" or "downstream" from the utility. This paper provides an assessment of the costs and benefits of bypass in natural gas local distribution markets. It develops a conceptual framework for analyzing the extent of natural monopoly in such markets and the desirability of institutionally protecting LDCs from competitive entry. The approach is to weave together stylized facts about downstream gas markets with insights from the theoretical and empirical literature on the economics of regulation, contestability, and sustainability. It describes the various regulatory and legislative changes in the gas industry that have increased the incidence of proposals for and in some cases the consummation of bypass. It also reviews the involvement of state legislatures, PUCs, and the courts in the natural gas bypass issue.

I. Introduction

Public utility markets in the United States are commonly subject to not only price, or rate, regulation, but also entry regulation. Within the past decade, however, as dissatisfaction with much of the nation's regulatory system has mounted, the rationale for, and indeed the practice of protecting utilities from competitors has come increasingly under attack. Numerous court cases and administrative rulings by regulatory agencies, as well as theoretical and empirical developments in the economics literature, have pointed to the benefits of allowing existing buyers or sellers of a utility's services to "bypass" the utility and instead transact for these services with either new entrants or incumbent members of the industry "upstream" or "downstream" from the utility.[1] Indeed, the issue of entry deregulation has been at the heart of debates over regulatory reform in such industries as the telecommunications industry, especially LATA (local access and transport area) markets[2]; the cable and satellite television transmission industry[3]; the postal service[4]; and the electric utility industry, especially cogeneration markets.[5]

Recently, the bypass issue has also come to the fore in the natural gas industry. Legislative changes under the Natural Gas Policy Act of 1978 (NGPA) and administrative reforms by the Federal Energy Regulatory Commission (FERC) have fundamentally transformed the way the wellhead and pipeline segments of the industry are regulated. The result is that greater competitive pressure and risk are being placed on downstream distribution markets.[6] For example, large industrial customers served by local distribution companies (LDCs) with relatively high rates are seeking ways to buy cheaper gas either directly from trunk system supplies of nearby interstate pipelines, or directly from producers (with the gas transported to the end-user via pipeline contract carriage). In addition, interstate pipeline companies burdened by excess deliverability are seeking new downstream customers, especially large industrial end-users. These types of challenges to the traditional control over downstream gas markets by LDCs are all taking place against a backdrop of unprecedented burner-tip competition between gas and other fuels, particularly oil.

Not surprisingly, attempts to bypass natural gas distribution companies have been extremely controversial. The battleground in which natural gas bypass policy is being fought is pitting bypassing industrial end-users against "captive" residential customers. It is also raising the thorny issue of the appropriate boundary between federal regulatory authority and state regulatory authority. And perhaps most important, it is prompting a fundamental assessment of the role of LDC service obligations and other elements of the traditional "regulatory bargain" between LDCs and public utilities commissions (PUCs). As a result, natural gas bypass policy increasingly is being determined through high-stakes court cases, impetuous resolutions adopted by state legislatures, unduly politicized decisions by public utility commissions, and heated arguments before FERC commissioners and administrative law judges. In short, "bypass" in natural gas has become an emotion-laden term.[7]

This paper provides an analysis of the issues surrounding bypass in natural gas local distribution markets. The ultimate objective of the paper is the development of a conceptual framework for analyzing the extent of natural monopoly in such markets and the desirability of institutionally protecting LDCs from competitive entry. We also provide a taxonomy of the costs and benefits of natural gas bypass. In pursuing that endeavor our approach is to weave together stylized facts about downstream gas markets with insights from the theoretical and empirical literature on the economics of regulation. It should be noted that in this literature the issue of whether free entry is generally desirable is not fully settled; in this sense, our discussion treads on the frontier of economic analysis. However, increasing numbers of economists would argue that the circumstances where regulation of entry is necessary to maximize economic welfare likely are narrower than previously thought. Thus, relative to the earlier literature on regulation, the burden of proof has begun to shift toward those who argue in favor of entry regulation. Our conclusions in this regard mirror the developments in the literature: While there are theoretical circumstances under which bypass in certain types of naturally monopolistic industries can be inefficient, we argue there is less need for the current scope of entry restrictions in natural gas markets than is commonly believed.

In order to set the stage for the discussion of the economics of entry regulation in local natural gas markets, the next section describes relevant developments in the gas industry. These include regulatory and legislative changes that have increased the incidence of proposals for and, in some cases, the consummation of bypass. We also describe the implications of such activity for the "regulatory bargain" that shapes the political economy of local gas utility regulation. Then, in the subsequent section, we review the involvement of state legislatures, PUCs, and the courts in the development of natural gas bypass policy. Following analysis of rationales for entry regulation and the wisdom of allowing bypass, the paper concludes with a discussion of the principal lessons for policy making.

II. Incentives and Constraints on LDC Bypass and Implications for the "Regulatory Bargain"

The process of regulatory reform of natural gas markets, which began in 1978 with wellhead price deregulation under the NGPA, has been working its way steadily downstream. The issue of LDC bypass is most directly traceable to major modifications in federal interstate pipeline regulation devised in October, 1985 under FERC Order 436.[8] A more recent FERC reform of pipeline regulation, Order 500, which was issued in August 1987, also directly affects the prospects for LDC bypass.[9]

Order 436 has created a number of incentives for LDC bypass. Most centrally, the Order gives pipeline customers potentially greater access to contract carriage service on the interstate trunk system. In particular, customers served by a pipeline that applies for (and receives) blanket authorization to become a nondiscriminatory contract carrier under Order 436, have a greater opportunity to purchase gas in the spot market and/or contract directly for supplies with gas producers. To the extent that these direct transactions provide end-users with gas costs which are lower than what their LDC charges, or deliveries under more reliable terms, there is an incentive to bypass the merchant function of the LDC.

If an LDC is unwilling to provide its own "unbundled", contract carriage service (thus, in effect, failing to extend downstream the contract carriage service originated by the interstate pipeline), or if such service is not competitively priced, an incentive to physically bypass the LDC is created. In other words, here the incentive is to bypass both the merchant and transport functions of the LDC. The distinction between such complete bypass and the partial type previously described is important since, as we argue more fully below, in certain cases the social interest in constraining entry (because of duplicative physical investments, etc.) is related primarily if not exclusively to the transport function, whereas in other cases, it is related to the transport as well as the merchant function.

Order 436, in fact, eases restrictions on pipelines' abilities to enter downstream end-use markets by building new facilities and selling either pipeline private carriage gas or pipeline contract carriage service directly to end-users. Specifically, in lieu of seeking approval for entry through the traditional and lengthy process of applying for a certificate of "convenience and necessity" under Section 7 of the Natural Gas Act of 1938 (NGA), Order 436 provides to pipelines which agree to operate as nondiscriminatory contract carriers expedited and pre-granted approval for entry. The primary stipulation for choosing this path for entry is that the pipeline company must bear all the risk for cost recovery from the new investments. This expedited entry permits pipelines to move rapidly and aggressively to seize market opportunities with reduced federal regulatory impediments.

In short, then, there are demand and supply forces under Order 436 which have combined to create incentives for bypass. The result, generally, is to create competition for LDCs by fostering new vertical transactional arrangements. On the demand-side, the competition comes from industrial end-users aggressively seeking to buy gas from suppliers other than LDCs. On the supply-side, the competition comes from pipelines seeking to sell gas to customers otherwise served by LDCs.

As the above discussion suggests, three factors invite such competition and thus are likely to provoke bypass. One is that an LDC may be saddled with relatively expensive city gate contracts with its pipeline-suppliers, resulting in an overall level of rates -- for sales, transportation, or both -- that is non-competitive either with other gas sources or alternate fuels. Secondly, the LDC's rate structure may be economically inefficient, with relatively high rates being charged to large industrial customers (which often have "interruptible" demand), and relatively low rates being charged to residential and small commercial customers (which typically have "firm" demand).

Finally, the LDC may not be offering the type of service desired by end-users. For example, in some cases large industrial customers have needs for "firm" private carriage service, but their LDC suppliers do not offer it to them. More commonly, bypass is provoked by unmet industrial customers' demands for LDC contract carriage service. By offering contract carriage service to meet these demands, an LDC may well give up a substantial contribution to its revenues in excess of variable costs that are otherwise earned from these customers' use of its (interruptible) private carriage service. Nevertheless, under such circumstances, there is at least some revenue contribution, rather than none at all as occurs if contract carriage is not offered and bypass is complete.

In the case of both rate structures and types (and terms) of service offered, the relevant decisions do not rest unilaterally with the LDCs. They are also under the purview of the PUCs. These state agencies have their own agendas and objectives that may or may not accord with the LDCs'. Thus, there are instances where LDCs desire to offer contract carriage service or discounted rates to industrial customers, but PUCs do not allow such requests to become operational (see further discussion below).

Notwithstanding the incentives toward bypass that it generates, certain provisions of Order 436 act as disincentives, or at least neutralizing agents, to bypass. These disincentives relate to the ability of an LDC to adjust its pipeline demand provisions in costly city gate contracts with its pipelines that opt for the Order 436 nondiscriminatory contract carriage certificates. In particular, under Order 436 an LDC is allowed to reduce with such pipelines its "firm" contract demand or reservation of pipeline transport capacity to zero over a period of five years. Alternatively, the LDC can convert its contract demand to "firm" transportation demand (according to the same time schedule). In either case, these provisions give LDCs the ability to potentially thwart end-user bypass investments that otherwise would be commercially viable.[10] However, these opportunities are diminished by Order 500, as noted below.

Order 500 has modified some of the incentives present in Order 436. Order 500 is a response to a June 1987 ruling by the Court of Appeals for the District of Columbia, which remanded Order 436 to the FERC.[11] In general, the Court reaffirmed the basic thrust of Order 436, which is to open up natural gas markets, from wellhead to burner-tip, to greater competition. The fulcrum that Order 436 uses to accomplish this goal is to change the nature of pipeline regulation. In this regard, the Court reaffirmed both the open access carriage and expedited entry provisions of Order 436. Apart from relatively minor technical changes, Order 500 leaves these intact. As a result, the pre-existing incentives for bypass have been retained.

In contrast, both the Court's ruling on the pipeline contract adjustment provisions of Order 436 and the way Order 500 modifies them, if anything, diminish the disincentives for bypass that previously existed. While the Court agreed with permitting LDCs to convert contract demand to "firm" transport capacity, it ruled that there was no legal basis for allowing LDCs to reduce their contract demand or "firm" transport capacity unless pipelines were permitted to be relieved of their corresponding citygate service obligations and their wellhead take-or-pay liabilities. As a result, Order 500 retains the Order 436 conversion provision; it eliminates the reduction provision. Inasmuch as this policy modification potentially limits an LDC's ability to switch away from relatively costly pipeline-suppliers, all other things equal, the prospects for bypass are increased.[12] Moreover, Order 500 permits a pipeline to devise inventory charges for its customers in order to provide for a type of cost-sharing scheme that mitigates its take-or-pay liability exposure. Again, all other things equal, this creates greater pressure for end-users to seek bypass.

Under both the NGA and NGPA, Congress appears to intend the FERC to have a role in the performance of downstream gas markets, even though these two statutes focus on the wellhead and pipeline segments of the industry. Orders 436 and 500, as well as other administrative reforms undertaken by the FERC in the last few years, make clear that the Commission takes this role seriously. There is little doubt, as outlined in the Orders, that the FERC wants to create an environment of competition in all gas markets and allow transactional arrangements and other institutions within the entire gas industry to evolve with market forces. Thus, the FERC's intent under Orders 436 and 500 is to create the opportunity in the industry's downstream segment for the market, rather than regulation, to determine both who buys gas from whom and where investments are made.

To be sure, as the evolution of events in gas markets since the passage of the NGPA demonstrates, the entire gas industry operates as a system. Changes at the wellhead reverberate downstream to burner-tip markets, and vice-versa.[13] The FERC's strategy of regulatory reform appears to conform with this belief. However, the FERC's jurisdiction is federal, and given that LDC bypass occurs at the state level, there is the potential that tension between state and federal regulation will arise. Indeed, as we discuss below, it already has. As we also show below, however, modifications of state policy can go a long way to harmonize the two jurisdictions.

For its part, the FERC has articulated in its various recent reforms how it sees the political economy of state-federal relations with respect to LDC bypass shaking out. FERC bypass policy is made explicit in Order 436 where, in its discussion of the new entry provisions, it states that as long as there are not "unfair competitive practices or other circumstances, bypass will be permitted." Clearly, the intent of these provisions is to propel pipelines to seek new downstream markets. More generally, the message of the FERC's reforms is that it will not protect LDCs -- or PUCs -- from competition. Indeed, if there are effects at the local level from FERC actions which create pressures on state policies, it is the PUCs' responsibility to devise policies that minimize or eliminate them. In the case of bypass, this can mean such adjustments as improved LDC rate design or the unbundling of LDC transportation.

As in other utility industries where bypass either has occurred or been proposed, bypass of natural gas distribution companies has raised the possibility that the customers remaining on an LDC's system after bypass will be charged higher rates because the bypassing customers will no longer be contributing to LDC's recovery of fixed costs. We discuss below the specific conditions under which such "cost-shifting" will take place. Suffice it to say here that there does exist considerable fear that this and/or other adverse effects will arise with LDC bypass. This fear has led to a variety of activities involving LDCs, PUCs, the FERC, state legislatures, consumer groups, and the courts to thwart bypass efforts; these are described in the next section.

The diversity of interests and responsibilities of the parties attempting to establish constraints on bypass speaks to the fundamental challenge that bypass poses to the practices and institutions, as well as the jurisdictional boundaries, that have traditionally governed the political economy of the gas utility industry. At the state level, an LDC typically is awarded an exclusive franchise to retail gas, with the proviso that the LDC has an "obligation to serve" all customers who wish service. In return, the LDC's profits, which LDC management has a responsibility to maximize for stockholders, are subject to regulation by the PUC. The PUC's task is to restrict prices, such that the LDC earns no more than a "fair" rate of return, where "fair" is generally interpreted as being in line with the LDC's cost of capital and commensurate with other firms similarly situated in the economy, e.g., in terms of exposure to risk. The PUC's oversight, however, is not absolute. Ultimately, the PUC is responsible to the state legislature, which grants the PUC its statutory authority. As a result, PUC decisions can be second-guessed by state politicians. While direct intervention into PUC affairs has not been practiced widely, implicit and explicit pressure by legislatures is not uncommon; and even absent implicit pressure, there is always the threat of legislature involvement. Needless to say, legislators are keenly aware of consumers' attitudes toward local energy policy; the electoral process guarantees they will have a certain degree of responsiveness to consumer dissatisfaction (or threat of such dissatisfaction).

At the federal level, interstate pipelines also have been subject to public utility-style rate of return regulation. While primarily confined to the wholesaling of gas to LDCs, many pipelines have engaged in a limited amount of direct sales to end-users. Historically, these direct sales have arisen somewhat idiosyncratically to meet the demands of industrial customers located near interstate systems and not otherwise served by an LDC. Until recently, aggressive moves that would take business away from LDCs have been rare.

The direct competition between pipelines and LDCs that bypass entails raises complicated questions of state versus federal rights. From a states' rights perspective, bypass can be argued to threaten the presumed exclusivity of LDC service franchises and, even more fundamentally, states' abilities to conduct economic and social policy through gas utility rates and policies. The counter-argument which supports federal jurisdiction over bypass notes that neither the shareholders of affected industrial gas users nor the ultimate buyers of such users' products reside entirely, or even predominantly, within the state where the gas is used. This gives federal authorities a broader clientele whose interests must be considered in policy deliberations.

The jurisdictional disputes engendered by bypass are placing strains on some of the long-unquestioned precepts of pipeline and, especially, LDC regulation. In resolving these disputes, policymakers will face important decisions concerning such issues as the limits of LDC service obligations, the entry and expansion rights of pipelines, and the use of retail rate structures. The implications of bypass for these kinds of issues are taken up in the following sections.

III. Recent Actions Shaping Bypass Policy

The growing tensions over appropriate bypass policy have been highlighted recently by specific activities of various PUCs and state legislatures, as well as by legal suits filed in the courts and before the FERC. Although systematic data on these activities are not available from one central source, or collected in a uniform manner, enough information can be obtained to put together a rough profile.

With respect to PUCs, information is available on a number of fronts. First, there are data on the incidence of bypass proposals within the geographical jurisdiction of a PUC. According to a recent survey sponsored by the Interstate Natural Gas Association of America (INGAA) of 22 PUCs (who comprise about 84% of the national gas market), between 1981 and 1985, 10 (who account for about 54% of the national market) had addressed proposals for bypass; the 12 other PUCs had no proposals for bypass come before them.[14]

Aside from the extent to which bypass activity took place within a PUC's geographical area, the INGAA survey yields information on the degree to which PUCs believe they have the legal authority to approve (or reject) bypass proposals. Whereas 2 of the 22 PUCs surveyed (about 11% of the national gas market) assert they have such authority, the vast majority (18 PUCs -- accounting for about 62% of the national market) claim their authority on bypass is legally untested and hence uncertain. Only 2 PUCs (representing about 11% of the national market) assert they do not possess the authority to rule on bypass. Different PUCs have adopted different roles in court and FERC cases over bypass: some have taken an activist posture (usually opposing bypass); others have been passive, letting the LDC (and aligned parties) alone sue the prospective bypassing customer and supplier.

One of the responses at the PUC level to prospective bypass has been to encourage LDCs to offer contract carriage service in order to attempt to preempt entry of new competition. A recent survey by the Missouri Public Service Commission sheds light on this score.[15] Of 44 PUCs surveyed, 9 indicate that LDCs in their states do not transport gas on a contract carriage basis. For the 35 PUCs indicating that contract carriage does take place in their states, the survey results suggest that the conditions under which such service is offered vary considerably from state to state. For example, only 10 of the surveyed PUCs have instituted a program of mandatory LDC contract carriage (California's unfolding program being the most far-reaching); in the 25 other states, the LDCs have discretion as to whether or not access to LDC contract carriage is offered (i.e., there is voluntary LDC contract carriage). Independent of whether or not access to LDC contract carriage is mandatory or voluntary, LDCs may or may not be required to post with their PUCs tariffs for contract carriage service. The Missouri PSC survey indicates that 24 of the responding PUCs mandate such tariffs to be filed.

Another policy that LDCs might pursue in order to attempt to preempt bypass is to provide special "incentive", i.e., discount, rates for their private carriage service to large industrial end-users, especially those with fuel switching capabilities. Scattered evidence suggests that many PUCs have established rules that allow LDCs to design rate structures along these lines, e.g., by setting industrial gas rates according to fuel oil prices.[16] Of course, not all LDCs who have this pricing option necessarily exercise it.

At the state legislature level a variety of information on bypass is available. Some legislatures, most notably Indiana's, have recently passed legislation that yields to PUCs authority to approve or deny bypass investment.[17] Other legislatures, for example Michigan's, passed such statutes many years ago.[18]

Another way legislatures have been developing bypass policy is to enact statutes which would require direct transactions between interstate pipelines and industrial customers to be subject to the normal certification process and rate regulation by the PUC, i.e., mandate that direct connection interstate pipelines operate as state-regulated public utilities. However, as of the beginning of 1986 this applied to only 10 states.[19] In most states, then, bypass investments are not considered public utilities in statutory terms.[20] This is usually because, as in the case of New York and Mississippi, there are provisions in state statutes which exempt "utilities" serving very small numbers of customers from PUC regulation.[21] Despite the relatively benign posture towards bypass that this evidence suggests, it should be noted that anecdotes abound about state legislatures threatening to propose statutes which either forbid outright bypass investments or which would require such enterprises to abide by "stringent" regulation, e.g., operate as common carriers.

State legislatures have also been active in developing statutes regarding LDC contract carriage. For example, legislatures in New York, Pennsylvania and West Virginia, among others, have recently passed laws that, in effect, instruct PUCs to design rules for mandatory contract carriage for the LDCs that operate within their states.[22]

Finally, bypass policy is being shaped by both administrative rule-makings before the FERC and litigation in the courts. While there are too many such cases to be described here, the most important and potentially precedent-setting ones deserve to be mentioned.

The most direct challenge to the FERC's interests in fostering new entry into gas markets was Associated Gas Distributors v. Federal Energy Regulatory Commission. In this case, LDCs challenged the components of Order 436 that encouraged bypass (see above). However, on June 23, 1987, the District of Columbia Court of Appeals essentially upheld the rights of the FERC to encourage competitive entry and bypass (although other aspects of Order 436 were less favorably received).

Apart from Associated Gas Distributors, perhaps the most significant case on the bypass issue to date is the May 1987 settlement of an antitrust suit, District of Columbia Hospital Energy Cooperative Inc. et al. v. Washington Gas Light Co.. The plaintiffs in the suit were a group of Washington, D.C. hospitals who had arranged for direct discounted spot purchases of gas from Yankee Resources, Inc., an independent supplier based in Ohio. The hospitals sought to have the local transportation of that gas carried out by their LDC, Washington Gas Light Co. (WGL). When WGL refused to perform the contract carriage service requested, the hospital sued, alleging that WGL was in violation of antitrust laws. In particular, they alleged that by refusing to provide distribution services, WGL was effectively extending a franchised monopoly in the transmission and distribution of gas into an unsanctioned monopoly in the purchase and sale of gas. The hospitals sought, among other things, a finding that WGL was abusing an "essential facility" and a directive requiring WGL to file a tariff for contract carriage service. Whether they ultimately would have sought complete bypass of WGL's system is not known. In any event, under the terms of the settlement, WGL agreed to seek regulatory approval from the D.C. Public Service Commission to carry out contract carriage service for gas customers within the District of Columbia. WGL filed its contract carriage tariff in June, 1987.[23]

Several bypass cases before the FERC are worth noting. Two of the more important ones were settled prior to the FERC rendering a final decision. One such case involved a Columbia Nitrogen Corp. fertilizer plant in Georgia that sought to bypass its LDC, Atlanta Gas Light Company. The proposed bypass would have entailed building a spur line of less than one mile in length to connect the Southern Natural Gas Pipeline Company to the fertilizer plant.[24] Columbia Nitrogen estimated that at the rates it was being charged by Atlanta Gas, it would have been able to save approximately $3 million annually through the bypass investment. Atlanta Gas argued that because it was Southern Natural's largest customer and Columbia Nitrogen was in turn Atlanta Gas' largest customer, the loss of load engendered by the bypass (approximately 70,000 MMBtu/day of interruptible sales) would have increased its overall average gas costs and resulted in a larger portion of its fixed costs being absorbed by its residential and small commercial customers. Atlanta Gas was joined in opposing Southern Natural's application before the FERC by other customers of Southern Natural, the Consumers' Utility Counsel of Georgia, and perhaps most important, the Georgia Public Service Commission (GPSC). Before the FERC was able to decide the case, the GPSC instituted rules allowing Atlanta Gas to offer both contract carriage service and market sensitive rates to industrial end-users. Upon the appearance of the improved service offering and lower tariffs, Columbia Nitrogen's bypass proposal was withdrawn.

A similar FERC case involved the Bethlehem Steel Corporation's Burns Harbor, Indiana plant and Bethlehem's LDC, the Northern Indiana Public Service Company (NIPSCO).[25] Bethlehem had proposed the building of a short pipeline that connected the Burns Harbor plant directly to the ANR Pipeline Company, one of the trunk lines from which NIPSCO purchases its gas. Bethlehem alleged that NIPSCO's rates for its interruptible supplies, which constituted the majority of Bethlehem's purchases from NIPSCO, were excessive. As a result, while the bypass spur with ANR would be used by Bethlehem to fulfill its interruptible requirements, Bethlehem would continue to rely on NIPSCO for its "firm" demands. Thus, Bethlehem was proposing only a partial bypass of NIPSCO's system. Unlike the Southern National case, the Indiana Public Service Commission did not join NIPSCO in formally opposing Bethlehem and ANR. But similar to the Southern Natural case, NIPSCO alleged that the Bethlehem ANR bypass would result in significant cost-shifting, burdening NIPSCO's residential and small commercial customers with the share of fixed costs otherwise covered by Bethlehem's revenue contribution to NIPSCO. Bethlehem argued before the FERC that because NIPSCO had an "inverted", economically inefficient rate structure, with interruptible rates exceeding "firm" rates, it had little choice but to propose the bypass. Ultimately, Bethlehem and ANR withdrew their proposal in return for NIPSCO significantly adjusting its rates for interruptible sales to Bethlehem.

Arguably, the most important FERC rule-making on bypass to date is the Commission's recent decision on a case involving Panhandle Eastern Pipeline Company, National Steel Corporation, and Michigan Consolidated Gas Company (MichCon).[26] National Steel arranged for direct purchases of gas supplies in Oklahoma from Union Texas Corporation at facilities that are connected to Panhandle's system. Because

Panhandle's pipeline runs through the property on which the National Steel plant in question is located, National Steel proposed connecting to Panhandle, which would then provide direct transportation to the plant rather than indirect transportation via MichCon's facilities. National Steel argued that at MichCon's current rates it could realize significant cost savings from the bypass of MichCon; however, National Steel noted that if MichCon lowered its rates it would regain the opportunity to provide service. But even with the direct connection to Panhandle, National Steel asserted it was going to seek other energy supply options as well, including ethane or the importation of gas from Canada, either through existing or new pipelines or by barge across the Detroit River. In effect, National Steel argued that it was embarking on a deliberate competitive strategy to diversify its energy sources and that regardless of whether or not the FERC approved the connection to Panhandle, it was going to arrange for alternative supplies rather than relying exclusively on MichCon's gas sales and/or transportation.

For its part, MichCon alleged that Panhandle was proposing to engage in a form of price discrimination in its transportation service that made it virtually impossible for MichCon to compete with the proposed bypass. Specifically, MichCon argued that Panhandle was prepared to charge National Steel a transportation rate that was in effect about half of what Panhandle was charging it for transportation. MichCon also contended that, more importantly, the loss of National Steel as its customer would result in a reduction of about $10 million in annual revenues to MichCon and, as a result, the costs previously apportioned to services to National Steel would have to be reapportioned to MichCon's remaining customers.

Ultimately, the FERC sided against MichCon and affirmed the administrative law judge's decision to grant Panhandle and National Steel their application for the bypass. The judge's decision noted, in part, that "the potential detriments to MichCon and its customers will occur even if the application is denied because National Steel has other viable supply options," and "the potential detriment to MichCon's customers from granting the application are speculative, 'since MichCon would not file for a rate increase with the Michigan Public Service Commission [(MPSC)] solely from the loss of National Steel's load'".[27] Thus, it was the FERC's judgement that because National Steel had alternative supply arrangements available, it already (or prospectively) had effectively bypassed MichCon. In addition, because MichCon did not intend to seek to raise its rates if the National Steel bypass was approved, the FERC in effect believed that any resulting losses need not be made up through higher rates for the remaining customers, but rather through a reduction in MichCon's profits.

Finally, it is worth describing briefly perhaps the most hotly contested bypass case that is currently in progress before the FERC. It involves the applications of two interstate pipeline companies, Mojave and Kern River, to directly serve enhanced oil recovery (EOR) gas customers in central California. The proposed systems would allow the EOR customers to bypass the intrastate distribution facilities of Pacific Gas and Electric (PG&E) and Southern California Gas (SoCal).[28]

California has long been a net importer of gas and at present all interstate lines terminate at the state border. From there, gas is fed from the pipeline networks through the state's LDCs. The state's EOR gas demand is sizeable and growing; estimates of its size range to more than 1 bcf/d by 1990. The bypass applications are a response to EOR producers' complaints that they have been disfavored customers in California, suffering under low quality, yet expensive service from PG&E and SoCal. The California Public Utility Commission (CPUC) -- a party to the case opposing the bypass -- has responded to the threat of competition by fashioning new rules designed to improve opportunities for service and to rationalize rates for the EOR gas market. The EOR producers contend, however, that if the threat of bypass were removed these rules would be modified and again they would be subject to the full force of PG&E's and SoCal's market power, as well as the political objectives of the CPUC.

The CPUC, PG&E, and SoCal argue that there is excess transmission capacity within the state for the EOR gas market and that the bypass will result in duplication of facilities. In addition, they allege that approving the bypass will mean a greater share of the utilities' fixed costs will be charged to the rest of their customers.

The California case will no doubt be an important one for the future of bypass policy if for no other reason than the size of the market at stake and the number of parties involved. Arguably one of its more interesting characteristics is that the EOR producers' position suggests that they find the political risks of conducting business with pipelines regulated by the federal government more palatable than the political risks of conducting business with LDCs regulated by the California state government. That may well be a harbinger of things to come in bypass cases in general.

IV. Bypass and the Theory of Entry Regulation

Up to this point we have needed to define only loosely what we mean by "bypass". However, in order to develop an analytical framework of the economic determinants and the costs and benefits of bypass, a more general and formal definition would be useful. Let us define bypass, then, in the following way. A regulated utility is bypassed when a customer discontinues the purchase of a service or product from the utility and instead: (i) buys the service or product from a utility in another service area ("horizontal competition"); (ii) buys the service or product from a party "upstream" or "downstream" from the utility ("vertical competition"); (iii) produces the service or product itself, for example, through internally producing synthetic natural gas, electrical cogeneration, etc. (vertical integration); or (iv) buys a service or product that is a close substitute to that otherwise provided by the utility, for example, through the use of dual-fired boilers or other means of fuel switching.[29]

The central economic implications of bypass can be segregated along familiar "efficiency and equity" lines. Within the context of regulatory practices that traditionally have protected exclusive territorial franchises from the threat of entry, the central efficiency question is: When is an incumbent utility susceptible to inefficient entry -- i.e., entry by a competitor which engenders social costs in excess of social benefits? This, in turn, raises other questions: How can competition exist in a market presumed to be a natural monopoly? If a regulated utility and competitors can co-exist, is the granting of an exclusive franchise to the utility warranted? By the same token, should the utility continue to be subject to a legal obligation to serve all customers in its service area? And, on what basis should entry be regulated? From an equity, or fairness, standpoint, if PUCs follow a de facto policy of guaranteeing gas utilities' fixed cost recovery, bypass can engender redistributions of the burden of fixed costs that are unlikely to ever be unanimously welcomed. This most certainly does not mean that bypass is necessarily a zero-sum or negative-sum event, but does imply the political tensions we have noted. In this and following sections, we examine the susceptibility of gas distribution markets to inefficient entry, and the types of costs and benefits attendant to bypass.

Against a backdrop of perceived sizeable losses in economic welfare and growing administrative burdens resulting from the regulation of a variety of industries, economists have been turning their attention toward re-examining the conditions under which government involvement in the marketplace is socially beneficial. One of the fruits of this process is a reaffirmation of the importance of the "conditions of entry" in affecting the ability of a market to perform efficiently, and the codification of this principle into the notion of "contestability."[30]

A monopolistically (or oligopolistically) structured market, where the threat of potential entry is sufficient to maintain the price and output levels that would occur if the market were competitively structured, is said to be contestable. In general, three conditions must prevail for a market to be contestable: (i) entry and exit from the market require limited sunk costs; (ii) all potential entrants have access to the technology employed by the incumbent firms; and (iii) when faced with the threat of entry, the incumbent firm cannot adjust prices (downward) instantaneously. When these conditions exist "hit and run" entry and exit are possible, and even a monopoly firm will, all other things equal, be disciplined by these forces to set its price and output at the competitive equilibrium.[31]

The policy prescription suggested by the principle of contestability is seemingly straightforward: for regulated markets which, due to changes in technology, major shifts in relative prices, or other reasons, become contestable, deregulation of entry and prices can be a welfare-improving public policy and thus should be pursued.[32] Several of the major deregulation initiatives consummated in the last decade have been based on this line of reasoning -- the deregulation of the aviation industry being the most celebrated case.[33]

Full-scale deregulation of an imperfectly structured but contestable regulated market is not, however, always socially optimal. In particular, in the case where "natural monopoly" conditions prevail, allowing competitive entry may entail social costs which then have to be weighed against the benefits engendered. One of the most important of such costs is the possibility that a new entrant's investment will result in an unnecessary duplication of existing facilities -- which would provide a strong rationale for regulating entry. This argument is usually advanced for cases where natural monopoly arises because of "economies of scale", i.e., where the average costs for producing a single product or service declines over the feasible range of output. However, if such economies truly exist, and potential competitors act rationally according to their self-interest, entry is unlikely to be consummated inasmuch as the incumbent firm can always undercut the entrant's price and thus entry will be unprofitable. In this case, the natural monopoly is "sustainable", and the social costs, if any, arising from deregulating entry are likely to be trivial.[34]

The concept of contestability hinges centrally on the mobility of capital. It is the ability of entrants to attack targets of profitability quickly that provides the discipline on incumbents' pricing and service offerings. The effectiveness of this discipline is virtually independent of the structural attributes that make a market more or less naturally monopolistic. That is, even markets that are structured monopolistically (or oligopolistically) can be made to behave competitively if entry is unregulated and the right to serve is contestable.

Clearly, the natural gas distribution industry is not characterized by highly mobile, quickly deployed and redeployed capital. In natural gas distribution, to incur the fixed costs of entry, to sink pipe in the ground, is to sink irretrievably significant capital costs. This essential aspect of the industry belies the possibility of hit and run entry, and renders reliance on contestability vain.[35] This implies that, where distribution markets are not (or can not be made) structurally competitive, a rationale exists for public-utility-style price regulation. But does it also mean that entry into such markets should be regulated (i.e.), restricted)?

Notwithstanding a general recognition of the benefits of easy entry, the foregoing question is motivated by the possibility that an industry which is most efficiently structured as a monopoly (or oligopoly) might not be able to sustain that structure if entry is unregulated. If, for example, one large LDC (or pipeline) can serve a given market more cheaply than some multiple of firms, allowing a multiple of firms to arise would constitute a wasteful duplication of facilities. Whether or not a policy of unregulated entry would permit such a result turns fundamentally upon the rates that the incumbent can charge and the services it can provide. In particular, if potential entrants anticipate that rates after entry will be insufficient to allow them to cover their costs, entry will be deterred and the incumbent's natural monopoly will be sustainable.

Perhaps the most important determinant of the sustainability of a market that is naturally and efficiently structured as a monopoly is the market's contestability. In fact, while contestability provides a justification for laissez faire in markets that are not naturally monopolistic, the tables are turned in the case where the efficient market structure calls for a single firm.[36] If entrants' capital is highly mobile and not sunk upon entry, new competitors can engage in hit and run entry into the incumbents' market (or some of its submarkets) whenever the incumbent loads fixed costs into rates at a level exceeding an entrant's costs. This could leave the incumbent with no set of rates that allow it to recover its costs and deter entry. When hit and run entry is possible, there can be an efficiency justification for restricting freedom of entry into otherwise naturally monopolistic (or oligopolistic) markets. Even when a naturally monopolistic market is contestable, however, restrictions on entry may be unwarranted or counterproductive, depending on other aspects (such as the pricing options open to incumbents -- see below) of the market and/or regulatory setting.

Notwithstanding their theoretical appeal, arguments for restrictions on entry into contestable natural monopoly markets have no obvious applicability to questions of bypass in natural gas distribution markets. Hit and run entry is wholly unrealistic in such markets, owing to the need to sink fixed costs in order to operate in the market. With distribution investments that cannot be freely pulled up and redeployed elsewhere, a new entrant can anticipate finding itself stuck in an industry already populated by an established competitor. This portends post-entry rates that result in losses; and this is even more likely to be the case if the established incumbent is, in fact, a natural monopolist and definitionally more efficient. In short, the sunk costs of distribution act as a barrier to entry and enhance the sustainability of incumbent companies' market positions.

Of course, a new entrant might be willing to get "stuck" in head to head competition with an incumbent regulated utility if the utility has little or no ability to respond to the entry with better offerings of its own. In the limit, if an incumbent utility were forbidden to respond to entry, an entrant might be more than anxious to sink its capital in a bypass and take away the incumbent's business. Responsiveness on the part of a regulated utility directly enhances its ability to sustain itself against the threat of entry.

In fact, natural gas utilities typically have the ability to respond to the prospect of entry with so-called "Mickey Mouse", multi-part rates, which leave prices at the margin (i.e., commodity charges) equal to incremental cost, and collect remaining fixed costs through inframarginal exactions (e.g., demand charges).[37] Such rate designs can enable even a natural monopolist facing contestability to sustain itself and deter entry.[38]

This conclusion is strongest in industrial end-use markets, where small numbers of sophisticated parties can meet to negotiate and tailor rates to specific contexts. Higher transactions costs and less sophisticated buyers make this less feasible in residential and commercial markets. These markets, however, have not been the target of bypass.

Clearly, the long-standing tradition of granting LDCs an exclusive franchise, which obligates them to serve all customers in a market but also protects them from competitive entry, can be interpreted as based on the notion that LDC markets are not sustainable. However, that tradition notwithstanding, today's literature, as reflected in the discussion above, suggests that sustaining otherwise naturally monopolistic structures in local gas distribution markets does not require draconian prohibitions on entry. Indeed, for utility markets in general, the literature suggests that, if anything, the scope of entry regulation required is probably more circumscribed than heretofore has been practiced.

The fact that the feasibilty of bypass and the sustainability of LDCs' monopolies is directly tied to rate design represents one of the many ways in which recent policy reforms have heightened the need to focus on rate structures in the gas industry.[39] In the bypass context, improved rate design, which allows for more efficient signalling of costs and demands, is likely to entail the unloading of fixed costs from LDCs' charges for marginal gas and transportation service -- and taking the current demand-commodity rate structure to its logical limits. Moreover, the allocation of the various classes and priorities (especially "firm" and "interruptible") of service on the basis of price, rather than politically-determined criteria of preference, would permit improved allocations of the services that LDCs and their competitors have to offer. Movement in this direction will require new approaches and contractual institutions such as inventory, exit, and/or reservation charges for customers' rights to call on LDC services; fully unbundled transportation and sales services; and more "market-based" allocations of access to LDC facilities of the kind contemplated at the federal level in the FERC's recent auction proposal for reservation rights on interstate pipelines.[40]

The observation that a monopolistic LDC that is naturally the least cost provider of the services that customers demand can effectively deter entry with appropriate rate designs provides, by reverse implication, insight into the origins of customers' interests in bypass. Specifically, inappropriate LDC rate designs and/or the inability to provide customers with the services they demand are the underlying roots of bypass.

As commonly phrased by LDCs and their respective public utility commissions, the "problem" of rate design lies in allocating the fixed costs of jointly used facilities across customer classes and types of service. Local gas distribution markets are not made up of a single, homogeneous class of customer. Rather, they are comprised of residential, commercial, and industrial gas users who commonly have different demand characteristics and desire different types or qualities of service. Perhaps the most familiar distinction between types of service is the "interruptible - firm" dichotomy; but customers also commonly differ in their needs for such attributes of LDCs' operations as gas brokerage services, storage services, and price and/or contract term reliability. LDCs with "economies of scope" can strive to serve these various needs from a single physical plant, meaning that customers share the use of at least some LDC facilities.[41] The allocation of the costs of jointly used facilities across LDCs' rates, however, presents both economic and political problems.

It is relatively easy for economists to describe and advocate first-best (i.e., most efficient) multi-part rate structures which show customers prices at the margin that equal incremental costs of service while collecting fixed costs inframarginally; or second-best (i.e., most efficient single-part) Ramsey pricing which loads fixed costs into prices in inverse proportion to how much system use is correspondingly discouraged through the elasticity of customers' demands.[42] LDCs and PUCs, however, do not make rates in an environment where economic efficiency is the sole objective of, or even well understood by, the parties involved. Rather, the parties to the ratemaking process -- including LDC management, PUC commissioners and staffs, involved politicians, and the various classes of customers -- quite naturally have conflicting private and social concerns over the burden of cost recovery. Similarly, to the extent that an LDC has limited capacity to provide particular types of service (e.g., high priority, "firm" service), parties to the ratemaking and regulatory process have conflicting private and social concerns. To say that the process is consequently highly political is to risk insulting the reader with the obvious.

The outcome of the LDC ratemaking process can quite easily be rate designs and corresponding allocations of types of service that call forth proposals for LDC bypass -- as our discussion of recent cases above suggests. To the extent that the politics of ratemaking result in burdens of LDC cost recovery on particular customer classes that exceed the costs of bypass, those customer classes have incentives to pursue bypass. Similarly, to the extent an LDC's service offerings leave certain customers' demands unmet, affected customers will have incentives to pursue bypass.

Clearly, incentives to pursue bypass can arise from the PUC regulatory process, as well as from the underlying cost structure (i.e., extent of economies of scale and of scope) of local gas distribution. This observation does not suggest that bypass proposals that arise "purely" because of untoward aspects of state regulatory processes are somehow economically unjustified; improved costs and/or quality of service for customers of a bypass constitute real economic benefits. However, the fact that a prospective or actual instance of bypass can impinge on state regulatory processes and lead them to different rate or service offerings than would otherwise be the case suggests that there can be both winners and losers, benefits and costs, to bypass competition.

Except in rare instances of unanimity, public policy choices necessarily involve some implicit or explicit comparisons of winners and losers, gains and losses; and economically efficient policies seek to promote the cases where the former exceed the latter. In this regard, the possibility that bypass can produce both winners and losers means that it is useful to contrast "socially economic" bypass from "socially uneconomic" bypass. For the sake of simplicity let us refer to the presumed beneficiaries of bypass as the "bypassers". In the common case in which the bypasser is an industrial end-user, e.g., a steel company, the beneficiaries generally include stockholders, as well as the final consumers of the affected industrial products and, perhaps, even labor. The parties presumed to be directly harmed by bypass can be designated the "remaining customers". A socially economic bypass can then be said to be one where the gains to the bypassers exceed the losses to the remaining customers. In such a case, regulation of entry is unwarranted and, on economic criteria, such bypass should be allowed. In contrast, where the losses to the remaining customers exceed the gains to the bypassers, i.e., the bypass is socially uneconomic, the economic criteria of efficiency imply that the bypass should not occur.

These policy conclusions risk mischaracterization as being policy choices. The way in which bypass is encountered by policymakers is as a request by a new competitor for the right to try to enter a market. The policymakers' decision does not cause customers to switch suppliers or bypass facilities to be built. Rather, the choice of the policymaker is whether to allow the competition to take place. The competition, in turn, will determine whether entry is successful. In fact, the policymaker can seldom be expected to have *ex ante* knowledge of the full costs and benefits of a particular bypass proposal. Thus, the salient issue that is faced is: if a proposed bypass is allowed to compete to enter the market, can competition between incumbent utilities and potential entrants be counted on to weed out socially uneconomic bypass proposals? This is the implied policy problem attendant to deregulating entry into gas distribution markets.

The question of the ability of competition to weed out inefficient entry is, of course, the question of the sustainability of local gas distribution companies' traditional monopoly (or oligopoly) positions. As we have stressed above, the sunk costs of established utilities act as a barrier to entry; indeed, a barrier to entry by even efficient bypass. When coupled with PUC-conferred abilities to respond to the threat of competition by means of rate and service redesigns, efficient utility service can be expected to be sustainable against the threat of entry.

Of course, one implication of allowing the market to decide the fate of bypass proposals is that even if inefficient entry is weeded out, the process of competition leading to such a result may engender alterations of utilities' pre-existing rate structures and service offerings. To the extent that this process results in rationalization of rate structures in accord with first-best or second-best marginal cost pricing principles, or the process results in improved service offerings to would-be bypassers, it is not a zero-sum process. Rather, the threat of competition yields improved efficiency.

In fact, the process of competition that weeds out uneconomic bypass need be no worse than zero-sum so long as PUCs and their utilities do not worsen rate designs by shifting foregone (fixed) cost recovery from prospective bypassers excessively heavily into other customers' rates for incremental service. That is, if the only benefit to prospective bypassers from bypass competition is a reduction in contributions to their utility's overhead, the implied burden on other ratepayers is an equivalent amount. More generally, however, it can be expected that the competition attendent to bypass would place pressure on utilities to improve rate designs and service offerings, as well as provide discipline on LDCs' operating efficiency. To note the potential of such benefits is not to say that bypass does not have its costs. We now turn to a more explicit consideration of the nature of the costs and benefits of allowing prospective entry by bypass.

V. The Benefits and Costs of LDC Bypass

Up to this point, the benefits and costs of bypass in local natural gas distribution markets have been discussed only in the aggregate and somewhat abstractly. The formulation of bypass policy, however, requires concrete consideration of a number of factors that determine these costs and benefits. What follows is an analysis of such factors. Because the analysis is intended to be comprehensive, most of the factors are described and assessed generally, rather than in the context of specific bypass cases. Moreover, the objective is to simply identify these factors; thus, there is no explicit attempt to assess their magnitude, rank them in order of importance, or attach weights to them.

From a welfare perspective, the benefits of bypass can be conceived of as the (consumer surplus) gains realized by bypassers. The costs of bypass (and the process of allowing competition over bypass) can be thought of as the burden imposed on those who lose. In this framework, the efficiency test for bypass amounts to assessing whether the "winners'" gains from bypass outweigh the "losers'" losses.

The losses attributable to bypass are commonly regarded as taking the form of a cost-shift from bypassers to remaining customers (ratepayers). A dollar-for-dollar cost-shift, however, is not a necessary result of bypass competition. There are essentially three places where any contribution to LDC overhead that is lost from bypassers can come to rest: other ratepayers, incumbent utility stockholders, and utilities' costs.

The view that bypass necessarily entails a cost-shift to other ratepayers is founded, in part, on the view that public utility regulation as applied to local gas distribution franchises operates according to textbook prescriptions: the public utility commissions allow LDC stockholders to recover the full costs of service, no more and no less. Moreover, according to theory, regulatory oversight guarantees that utilities provide the services they do in a least-cost, technically efficient manner. In this setting, the loss of bypassers' business forces the regulatory process to look to other ratepayers to make up bypassers' contribution to cost recovery.

Obviously, regulatory practices can and do differ from theory. The process of utility ratemaking takes place in a political context. As our review of recent cases indicates, the prospect of lost overhead contribution from prospective bypassers is understandably met with disapproval by both remaining customers and LDC stockholders, therein suggesting that the welfare burden of bypass is split among various parties. The opposition of remaining customers to higher prices for delivered natural gas, as mediated by the PUC process, translates into pressure to force LDC stockholders to bear the brunt of lost overhead contribution from bypassers. In turn, the opposition of stockholders to reduced profits translates into pressure on LDC management to absorb the impact of bypass through improved operating efficiency and associated cost reductions.

In general, the impacts of bypass can be expected to be split between the three possible outcomes -- "cost-shift", "profit-squeeze", and "cost-squeeze". The textbook result of a dollar-for-dollar cost-shift to other ratepayers represents a limiting, extreme case. More realistically, the experience of public utility regulation suggests that LDCs seldom operate on the knife-edges of both technical efficiency and zero economic profits.[43] That is, there is "fat" that gets squeezed when a political equilibrium is upset by an event such as bypass. Of course, to the extent that the result is improved LDC cost efficiency, there are no losers from bypass; there are only pure efficiency gains. When the burden of bypass falls on other ratepayers and on stockholders, however, an economic welfare analysis must compare these parties' losses to the benefits realized by bypassers.

There are four generic classes of socially productive benefits that may be attributable to subjecting LDCs to competition from potential entrants. These are: rate effects, service effects, risk effects, and competitive effects.

Beneficial rate effects refer to the ability of actual or prospective bypass to lower the marginal expense of delivered gas to bypassing end-users. Any induced reduction in the expenses that affected end-users pay at the margin to acquire delivered gas results in increased gas use. So long as expenses at the margin are not below the marginal resource costs of service, this increased use yields net social benefits. Of course, an LDC could choose to offset such benefits by perversely responding with incremental (commodity) rates for remaining customers that are higher.

Our review above of recent cases of proposed bypass reveals that dissatisfaction with the quality of LDC service can be an important impetus to bypass. Two attributes of service are frequently at issue. One is delivery reliability. Low priority service is a de jure or de facto reality for many industrial customers of local distribution companies. The political, if not economic, need of granting higher priority to other users is frequently manifested, for example, in the inability of industrial end-users to purchase "firm" service from LDCs. We do not mean to imply that LDCs can or should ignore political necessities in establishing priorities of service. We mean only that, in the process of establishing de jure or de facto priorities, certain customers demands may go unmet. In such circumstances bypass may be the only mechanism by which industrial end-users are able to buy service of the quality they desire.

A second form of service improvement that end-users may derive from the opportunity to bypass their LDCs is access to unbundled LDC transportation service. As federal policy has moved interstate pipelines into an era of increasingly unbundled, open access transportation, many end-users who are sophisticated enough to take advantage of the implied opportunities have been blocked from doing so by lack of access to unbundled LDC transportation (see Section III above). The prospect of bypass can induce LDCs (and their PUCs) to respond to these customers' demands; and consummated bypass can directly link them to the nation's emerging open access transportation grid.

Closely related to the service effects of bypass are the risk effects. Industrial end-users can demand not only reliability of physical deliveries (giving rise to "service" benefits of bypass), they can also require reliability in the contractual terms and conditions of gas delivery service. If de jure or de facto low priority before PUCs manifests itself in relatively high risks of changes in the terms and conditions under which LDC service is had, industrial end-users' costs can be raised (as they self-insure through, e.g., fuel switching installations), long-term planning can be inhibited, and investment can be discouraged. Such consequences are what it means to say risk is a cost.

For reasons beyond our focus here, state public utility commissions have a difficult time binding themselves to credible bargains of the type demanded by some industrial gas users -- and this problem appears to have been magnified in recent years.[44] Bypass can provide an answer. Even the mere threat of entry can do so: Prospective bypass may induce LDCs, and especially their respective PUCs, to improve the reliability of the terms and conditions under which local distribution services are provided. Where the prospect for bypass is sufficient, bypass may be actually consummated. As stressed above, this commonly means turning from state-regulated distribution entities to FERC-regulated pipeline facilities. Although there is no theoretical necessity that federal jurisdiction provides more reliable terms and conditions of service, permitting bypass to occur allows end-users to "vote with their feet" on the matter. At the very least, access to both state and federally regulated facilities sets up inter-jurisdiction competition and a method by which bypassing end-users can hedge the risks they face.

Apart from improvements in rates, service, and reliability, allowing bypass can produce generalized competitive benefits. For example, insofar as prospective bypass induces LDCs to offer unbundled transportation, or consummated bypass links large end-users directly to open access interstate systems, additional competitors are introduced into the market for buying gas. This not only tends to dampen any latent upstream monopoly power, but it also effectively offsets LDCs' structural monopolies as local gas brokers. Finally, as noted, competition from bypass coupled with remaining customers' and LDC stockholders' resistance to the burden of a cost-shift may induce efficient cost reductions for all LDC operations.

Having thus far focused on the benefits of bypass, it is important to point out that bypass is not free. The central cost of a consummated bypass is the cost of the bypass facilities themselves. Whether or not new physical facilities are economically duplicative, their use of labor and capital represent real resource costs. From a policy perspective, these stand as debits against any benefits bypassers realize. New facilities can be considered economically duplicative precisely to the extent their costs are not offset by benefits of the kinds we have described.

When the benefits of a bypass extend beyond simple delivery of gas to include the provision of improved service quality and/or risk reduction, an apparent physical duplication of facilities provides little insight into the outcome of a social cost-benefit test.

One important point should be noted here. Some degree of physical duplication of facilities may well be optimal. For example, many gas (and electric) utilities maintain capacity reserve margins as a form of insurance against the risk of short-run increases in demand and/or to provide needed capacity during maintenance periods. End-users' bypass investments can function in much the same way. Similarly, end-users may have dual-fired boilers or other types of fuel-switching capabilities, and we have already alluded to the fact that these facilities are tantamount to bypass investments. They also can be viewed as constituting duplications of physical facilities. Yet, such investments are usually considered socially beneficial insofar as they result in a more flexible energy-using capital stock.

If the construction of bypass facilities permits an affected LDC to avoid building, repairing and/or maintaining facilities of its own, the resulting avoided costs can be appropriately thought of as a benefit of bypass. Equilivently, the net cost of bypass facilities can be thought of as being less than the gross cost when bypass displaces investments an LDC would otherwise have to make.

A consummated bypass clearly displaces the variable costs that an affected LDC would otherwise incur. This is a benefit of bypass. Of course, against the savings of LDCs' variable costs must be set the variable expenses of operating the bypass facilities. A priori, it is not possible to say which supply system, LDC or bypass, has the lowest operating costs. The comparison depends upon such factors as the relative distances over which the alternative systems travel and the extent of any technological improvements embodied in the bypass' newer facilities.

VI. Conclusion

The most useful way to conclude this paper is to summarize the salient lessons suggested by the foregoing analysis for the development of bypass policy.

The most critical lesson is that, given the complexities and uncertainties associated with assessing whether a particular bypass proposal produces positive net social benefits, bypass policy should carry an adoptive presumption in favor of competition, rather than protection of monopoly. Thus, if there is to be a bias in policy, it should be towards rather than away from bypass. This conclusion derives from the literature on the economics of regulation. Here the burden of proof is clearly defined in terms of: Where is regulation necessary?; and not in terms of: Where is competition excessive?

The core of the case for bypass is found in two themes. First, entry and the threat of entry have the capacity to discipline regulated gas distribution markets in socially productive ways. Bypass and its threat can increase the pressure on local utilities to hold down their costs, rationalize their rate structures, and improve the range and quality of their service offerings.

Second, entry by socially inefficient bypass proposals is unlikely to be successful. Given that LDCs (and PUCs) can respond to the prospect of entry with improved rate designs and that LDCs' fixed costs are largely sunk, there exist significant deterrents to inefficient entry. Particularly in the context where bypass commonly arises -- industrial markets populated by relatively small numbers of sophisticated participants -- efficient natural monopoly in local gas distribution can be expected to be sustainable. Restrictions on entry accordingly can be relaxed.

Effective threats of bypass clearly can impinge on ratemaking for local gas distribution utilities. This has both economic and political implications. With regard to the former, reforming LDC rate structures so that they are more in line with basic principles of economic efficiency would not only be an important step in improving LDC market performance overall, but would also reduce (artificial) incentives for bypass. Indeed, it is arguable that one of the reasons why bypass has become such a major policy issue is that PUCs have not encouraged LDCs to offer flexible and fuel-sensitive rates to industrial end-users.

In fact, many PUCs have followed a regulatory policy of tilting rates, not to mention service priorities and quality, in favor of residential and small commercial customers. In part, these policies have been based on the politics of LDC regulation. These have generated a belief -- equally shared by PUCs and LDCs -- that competition in gas markets stops at the city-gate. But, if there is one conclusion to be drawn in this regard in the aftermath of FERC Orders 436 and 500, it is that wellhead competition in the gas industry reverberates rather effectively and directly downstream to the burner-tip, and conversely. The result is that any attempt to devise an effective bypass policy in downstream markets necessarily must entail significant LDC rate structure reform.

The notion that reform of price regulation and the relaxation of entry restrictions are linked manifests itself in a number of ways. For example, not only is the need for entry regulation diminished with a more efficient pattern of rates, but also with the introduction of new types of pricing institutions. Measures such as the loading of fixed costs into inframarginal charges, exit and reservation fees, and price allocation of service priorities can play powerful roles in market signalling. This signalling consists of transmitting information about demand and supply in current time periods as well as prospectively.[45] With improved price institutions in place, a policy which expands the scope of the market at the expense of FERC and state regulation in determining the amount of bypass that occurs becomes tenable, indeed attractive.

Our analysis should make it clear why a blanket ban on bypass is unsound public policy. On the one hand, with more efficient pricing schemes, the incidence of bypass proposals, let alone the amount of bypass actually consummated, will surely diminish. On the other hand, opportunities for credible threats of bypass must be preserved. For as we have seen above, the threat of bypass alone enhances the performance of both LDCs and PUCs. In this regard, a banning of bypass would create deleterious effects akin to those that would arise in the so-called "market for corporate control" if an absolute ban on mergers among the largest industrial corporations were instituted. The argument in favor of allowing bypass is not that bypass per se is desirable. Rather, permitting bypass engenders positive effects by enhancing gas market competition.

NOTES

[1] Below we give a more general and formal definition of bypass.

[2] See, for example, B.L. Copeland, Jr. and A. Severn, "Price Theory and Telecommunications Regulation: A Dissenting View," *Yale Journal on Regulation*, Vol. 3, 1985.

[3] See, for example, B.M. Owen, "The Rise and Fall of Cable Television Regulation," in L.W. Weiss and M.W. Klass, eds., *Case Studies in Regulation* (Boston: Little, Brown, 1981).

[4] See, for example, R. Sherman, "Pricing Policies of the U.S. Postal Service" in *Regulated Industries and Public Enterprise: An International Perspective,* edited by B.M. Mitchell and P.R. Kleindorfer (Lexington, MA: Lexington Books, 1980).

[5] See, for example, P. Joskow and R. Schmalensee, *Markets for Power: An Analysis of Electric Utility Deregulation* (Cambridge, MA: MIT Press, 1983).

[6] For an overview of the recent policy changes that have taken place in the gas industry see H.G. Broadman, "Natural Gas Deregulation: The Need for Further Reform," *Journal of Policy Analysis and Management,* Vol. 5, No. 3, May 1986.

[7] For a sampling of the controversy, see R.W. Stewart, "Natural Gas on a Frontier of New Challenges," *Public Utilities Fortnightly,* May 14, 1987, and C.C. Blaydon, "State Policies under Pressure" and R. Johnston and D. Sullins, "Comments on Blaydon," in J.P. Kalt and F.C. Schuller, eds., *Drawing the Line on Natural Gas Regulation: The Harvard Study on the Future of Natural Gas* (New York: Quorum Books, 1987).

[8] For a detailed description and critique of Order 436 see H.G. Broadman, "Deregulating Entry and Access to Pipelines," in J.P. Kalt and F.C. Schuller, eds., *Drawing the Line on Natural Gas Regulation: The Harvard Study on the Future of Natural Gas* (New York: Quorum Books, 1987).

[9] For an overview of Order 500 see "Washington Letter", Vol. XX, Issue 33: August 14, 1987, American Gas Association, Arlington, VA.

[10] Of course, this ability is contingent upon the LDC's pipeline-supplier(s) volunteering to be nondiscriminatory contract carriers. Given that these reductions and conversions of contract demand and transport capacity amount to a form of pipeline bypass, pipeline companies have a disincentive to apply for nondiscriminatory contract carrier status. Indeed, instead, in concert with end-users, they may prefer to attempt to bypass the LDC.

[11] Because of the unfavorable impact of the court's ruling on bypass, it is not clear, at this writing, whether groups representing distributors will appeal the decision to the U.S. Supreme Court in the hopes of having it overturned. Thus the duration of Order 500 is not certain at this point in time.

[12] To be sure, an LDC could still combat bypass by converting to transportation and securing cheaper gas than system supply if that is the root of the problem. Alternatively, an LDC can now also unbundle and offer contract carriage service and face a bypass threat only if pipelines not serving the LDC can build spurs to its customers and offer gas enough cheaper to compensate for the new investment costs.

[13] For analysis of the interrelatedness of gas markets see H.G. Broadman and W.D. Montgomery, Natural Gas Markets After Deregulation (Washington: Resources for the Future/Johns Hopkins University Press, 1983).

[14] Interstate Natural Gas Association of America, "The Interplay of Federal and Consuming State Regulations, " Research Report 86-3, March, 1986.

[15] Public Service Commission of Missouri, "The Instigation of Developments in the Transportation of Natural Gas and Their Relevance to the Regulation of Natural Gas Corporations in Missouri," May, 1986.

[16] See for example, J.D. Lambert, "Bypass in the Natural Gas Industry: The Fruit of Regulatory Change," Public Utilities Fortnightly, April 3, 1986.

[17] Indiana passed such a law in 1985.

[18] Michigan's law dates back to 1929.

[19] See "Inside FERC", December 23, 1985.

[20] PUCs, of course, can assert that their jurisdiction covers direct sales made locally by an interstate pipeline, but these assertions must inevitably stand the test of the legislature and the courts. For a sampling of PUC decisions in this regard see L.A. Burkhart, "Gas System Bypass: Can States Regulate Direct Sales by Interstate Pipelines," Public Utilities Fortnightly, July 9, 1987.

[21] See INGAA, "The Interplay of Federal and Consuming State Regulations."

[22] See Lambert, "Bypass in the Natural Gas Industry."

[23] While the case focused on the hospitals' desire for contract carriage access to WGL's system, recently the hospitals appealed the rates WGL filed for such service,

alleging that they are set too high. See "Bargain-Price Natural Gas Flowing to Area Hospitals," Washington Post, p. D9, August 29, 1987.

[24] See FERC Docket No. CP85-529

[25] See FERC Docket No. CP84-386. We note that both authors served as consultants to Bethlehem for this case.

[26] See FERC Docket No. CP86-232.

[27] See Opinion No. 275-A, FERC Docket No. CP-86-232, issued September 10, 1987.

[28] See FERC Dockets No. CP85-437 and No. CP85-552 and Inside FERC July 1, 1985 and July 15, 1985. We note that Kalt is serving as a consultant to Mojave in this case.

[29] Note this implies that objections to bypass are tantamount to objections to fuel-switching, or in general, to alterations to the capital stock that make it more flexible in terms of energy usage.

[30] See W. Baumol, J. Panzar, and R. Willig, Contestable Markets and the Theory of Industry Structure (New York: Harcourt Brace Jovanovich, 1982) and W.G. Shepherd, "Contestability versus Competition," American Economic Review September, 1984.

[31] Obviously the opposite extreme of a monopoly market, the textbook "perfectly competitive" market, is necessarily a contestable market.

[32] Of course, this assumes that regulation of such markets was justified initially; this would not be the case if the markets were contestable to begin with.

[33] See E. Bailey, D. Graham, and D. Kaplan, Deregulating the Airlines (Cambridge: MIT Press, 1985).

[34] The genesis of the "sustainability" literature is J. Panzar and R. Willig, "Free Entry and the Sustainability of Natural Monopoly," Bell Journal of Economics Vol. 8, No. 1, Spring 1977.

[35] Similar conditions prevail in the pipeline segment of the industry. See H. G. Broadman, "Competition in Natural Gas Pipeline Wellhead Supply Purchases," The Energy Journal, Vol. 8, No. 3, 1987, and H. G. Broadman and M. A. Toman, "Non-Price Provisions in Long-Term Natural Gas Contracts," Land Economics, Vol. 62, No. 2, May 1986.

[36] Baumol, Panzar, and Willig, op. cit., note that: "Where markets are perfectly contestable and monopoly is natural but unsustainable, limitations upon entry may be needed to ensure

that the socially optimal set of products can be produced in the most efficient manner" (pp. 222-23). In short, while contestability is a necessary condition for the deregulation of entry to maximize economic efficiency, it is not sufficient. Sufficiency requires that the market in question be not only contestable, but also sustainable.

[37] On "Mickey Mouse" pricing, see W.Y. Oi, "A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly," Quarterly Journal of Economics, February 1971.

[38] See e.g., M. Perry, "Sustainable Positive Profit, Multiple Price Strategies in Contestable Markets," J. of Economic Theory, 1984.

[39] See, for example, Office of Pipeline and Producer Regulation and Office of Economic Policy, FERC, "Gas Transportation Rate Design and the Use of Auctions to Allocate Capacity," July 1987.

[40] Ibid.

[41] Economies of scope arise when the total cost of producing (delivering) two or more products (services) jointly is less than the sum of producing (delivering) each separately. For more discussion see, for example, E. Zajac, Fairness or Efficiency: An Introduction to Public Utility Pricing (Cambridge: Ballinger, 1978).

[42] Ramsey pricing refers to a scheme developed in F. Ramsey, "A Contribution to the Theory of Taxation," Economic Journal Vol. 37, 1927. The most comprehensive restatement is in W. Baumol and D. Bradford, "Optimal Departures From Marginal Cost Pricing," American Economic Review, Vol. 60, 1970.

[43] Joskow, P., "Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation," J. of Law and Economics. October 1974.

[44] See Kalt, J., H. Lee, and H. Leonard, "Reestablishing the Regulatory Bargain in the Electric Power Industry," in W. Hogan, at al., Final Report of the Boston Edition Review Panel, 1987.

[45] That is to say, needed pricing reforms go beyond simple, static inverse-elasticity modifications and should include seasonal pricing schemes and restructuring of variable and demand charges. For further discussion see H.G. Broadman and W.D. Montgomery, Natural Gas Markets After Deregulation (Washington: Resources for the Future/Johns Hopkins University Press, 1983).

Senator **Nickles**. Mr. Chairman, number one, I want to apologize to our first witness. I didn't catch all of his statements.

Mr. **Gerarden**. I would be happy to repeat them.

Senator **Nickles**. That might be acceptable to me. I am not sure it would be acceptable to the chairman who I know has other demands on his time as well. But you are representing Cascade Natural Gas?

Mr. **Gerarden**. Yes, sir.

Senator **Nickles**. Cascade filed a complaint before FERC?

Mr. **Gerarden**. Yes, it did.

Senator **Nickles**. That complaint was denied?

Mr. **Gerarden**. Yes, July 19th of this year.

Senator **Nickles**. Would this legislation overrule FERC?

Mr. **Gerarden**. The two bills have somewhat different approaches to bypasses that are already in place. And it would depend upon which of the bills or what final version came out as to whether it would have an impact on the one bypass that is the subject of that complaint.

In future cases legislation would provide a role for the states and local distribution companies so long as the LDC is willing to transport the gas on a nondiscriminatory basis under state-approved rates to prevent a bypass. Then it would place in the hands of the state commissions the role of fashioning the price, the terms of service by the LDC. That would enable the LDC to keep that industrial customer on line.

Senator **Nickles**. Legislation would normally apply to pipelines under federal jurisdiction, would they not?

Mr. **Gerarden**. It would apply to any pipeline under FERC jurisdiction. It would in essence say that the FERC cannot permit a bypass if the state commission certifies to the FERC that there would be prejudicial effects on other customers of the local distribution company and the local distribution company agrees to transport gas on a nondiscriminatory basis under the terms that the state agency sets. That is the basic approach of S. 2313.

Senator **Nickles**. I am just glancing, and again, I am not that familiar with the case that Cascade brought before FERC, but just looking at part of their summation, they state that they find the pipeline which Chevron constructed between Finlay and Kennewick plants to be nonjurisdictional and not subject to section 7c. So, I think you would lose anyway.

Mr. **Gerarden**. That is a second issue as to the one-mile pipeline that Chevron constructed. But Chevron's ability to take gas is dependent on Northwest being allowed to transport bypass gas to Chevron at the interconnect with that one-mile pipeline.

Our complaint to the FERC centered on the authority under which Northwest was transporting that gas to the Chevron pipeline. We believe that the use of section 311 of the NGPA and the interpretation that the commission has given to the Congressional test, the on behalf of test, is not faithful to Congressional intent, and that the transportation cannot be allowed on that basis.

Now, the legislation does more than our complaint would do. Our complaint is just trying to——

Senator **Nickles**. Let me ask you the question very directly. I do not see the legislation overturning this decision. Do you agree or disagree?

Mr. **Gerarden**. S. 2313 would not prevent that bypass which already has occurred, but it would prevent a future one of similar nature because it would tell the commission that it cannot use any of its authorities other than the Natural Gas Act or the Natural Gas Policy Act to permit a bypass transaction if the state commission objects and the LDC will transport from the interstate pipeline.

Senator **Nickles**. I was really seeking an answer. I do not want to discuss this case all that much. Again, I am not an expert on it. It just occurred to me that the legislation that we have before us in all likelihood would not reverse this decision.

If in your thoughts you wish to what, greatly increase I guess I would say the power or the role that LDC's have in any bypass and giving them the ability to veto or deny bypasses?

Mr. **Gerarden**. I hesitate to put it in the terms of a veto of bypass. The LDC would have to be willing to transport gas and transport gas under the terms that the state commission sets.

That means an industrial customer who is facing a problem needs lower cost service, then go to that state commission and say the rate, the industrial rate by my LDC needs to be lower. And the state commission would have the authority to adjust its rates. And so it places that sort of decision in the hands of the local agency.

The LDC under these bills would not have an absolute veto. If the LDC is not willing to open its system, if the states do not see a prejudicial impact by a bypass, there could be many small bypasses where they wouldn't see a prejudicial impact, and that bypass could go forward.

Senator **Nickles**. Can you not see in many circumstances where bypasses could be to the advantage of not only the ultimate user, but also to the pipeline, to the producer, to the economy in the event of maybe a settlement not being reached with LDC and if you had a situation where agreement just could not be reached where you might have a loss of jobs, you might have a shutdown of a plant where bypass might be able to prevent that from happening?

Mr. **Gerarden**. Yes, sir, there could be situations like that. In our view, the state commission should have a say in how the rates for the local distribution company should be structured to save that plant, to keep that plant operating, and to keep those jobs in place. It is a balancing of differing economic impacts.

Now, I would say in respect to Mr. Bush's remarks no one in the industry, producers, pipelines or LDC's makes money unless producers sell gas. We are not trying to restrict the expansion of gas service in this country.

What we are trying to do is to put some balance into the system so that state agencies have a role in setting rates for service by local distribution companies that will keep industrial customers on the line and also spread the costs that not all of the captive residential and small commercial customers have to bear the cost of the local distribution system while the industrial customer builds a little separate line for itself over to the pipeline.

Senator NICKLES. Do you see a situation—I guess I would not mention one of the concerns I have, and again, I mention my prejudice. I am from a natural gas state. I desire to see the natural gas industry grow, and I think it can. I believe that it will. I would be concerned that if this legislation would pass that you would very much impede not only bypass but the production one, and maybe I will direct this to Mr. Bush or Mr. Halvorsen.

But, one, are there a great number of cases where this has happened, estimated to happen? And, two, if it is not allowed to happen or if you do not allow this I guess flexibility for bypass, would you have an increase in alternate fuels, maybe number six or other types of fuels that would replace natural gas by an industrial customer?

Mr. HALVORSEN. Senator, if I could respond to that. Many of my members, the pipelines have gone to the LDC's and assured them that they have no interest in bypassing. Again, the LDC's are our best customers, and I think there have been three cases considered by the commission over the last three years. Ms. Cook can address that more directly, but, again, there is no big conspiracy out there on behalf of the pipelines to push for a massive effort to bypass the LDC's.

Senator NICKLES. So, you really do not see any need for this legislation?

Mr. HALVORSEN. Absolutely not.

Senator NICKLES. Only three cases that you are aware of?

Mr. BUSH. Even more, Senator, there are probably as many bypasses of pipelines by LDC's as there are of any other proposals to bypass LDC's that have, in effect, taken a place.

As I mentioned in the Atlantic Gas Light situation is a perfect example of having a problem with Sonat's, you know, WACOG, its price of gas, so it decides to build a cheaper pipe to go up to Tennessee, put some competitive pressure on.

All we are saying is what is good for the goose is good for the gander.

The introduction of competition into the NDC or LDC world is frightening to them because it obviously is going to result—you see, this argument over the residential use, the homeowners suffering, it is a kind of a textbook prescription of old economics about how if LDC's only can recover their fair right of what full cost of service, but that in reality is not what happens.

What happens more often than not is that there is a three-pronged place where those costs lie. First, there is the effort, the traditional effort by the LDC that if a bypasser's contribution is tried to recover through the ratepayer, the ratepayer gets upset and he goes to the PUC and objects, and that puts pressure on the stockholders to bear some of these costs, just as with a passer of take or pay liabilities, for instance, in the pipeline community. There has been pressure for the stockholder to bear some of those costs.

And, finally, when the stockholder then objects to the reduction in the profits that are potentially there, there is the ultimate pressure on the LDC management to increase its technical efficiency and reduce its costs.

And I can understand and empathize with any businessman, and an LDC is a businessman, he is not only a regulated utility, he is a businessman. I can understand the fear with which he views that prospect that inevitably somebody is going to be down trying to reduce costs.

But the fact is that in the world we are living in, it is not just—it is not just nice that they do that, it absolutely essential that LDC's have this competitive pressure put on them so that every ounce of fat in the marginal costs of these utilities are taken out. That is the only way we are going to reduce the net back to the wellhead and get the best possible price for wellhead gas. It is the only way we are going to get the most competitive price at the burner tip.

And I empathize with their—you know, we are all suffering through this transition into a more competitive environment. But to try to isolate yourself and protect yourself under the old world, why you subject every other aspect of this industry to that kind of pressure. It may be understandable, but I would suggest to you that the Congress should not engage in it.

Senator NICKLES. Thank you very much. Mr. Chairman, thank you.

Senator FOWLER. In line with Mr. Nickles' earlier question and also following up to a certain extent with what Mr. Bush just said, Mr. Gerarden, in reaction to that if Cascade had access to cheaper firm gas supplies from another pipeline, would it attempt to bypass or negotiate a better deal from its traditional pipeline supplier?

Mr. GERARDEN. If that were the case, Cascade certainly would try to get the lowest possible cost to service. In the Pacific Northwest, as a practical matter, there is no such option. Northwest is the only pipeline in our vicinity that markets are not going to support another pipeline being built to give us that option.

I might add that Cascade is not afraid of competition. Cascade first got authorization from the State commission to transport gas for an industrial customer in October of 1980. The customer was Chevron. We could not actually move the gas until February of 1982 because Northwest did not have authority to do it.

And as far as LDC's bypassing the pipelines, there are two ways you have to look at that. One is that under open access transportation regulations, LDC's do have the opportunity now to go buy spot gas. Mr. Bush has characterized that as a bypass of sort. Well, it is a bypass in the sense that they are bypassing the pipelines' sales service.

But when Cascade goes out in the field, buys spot gas as it does now, that gas goes through the Northwest pipeline. Northwest is paid for the transportation. The throughput is the same. There is no physical bypass in Northwest pipeline.

Cascade takes those lower cost gas supplies, and they are substantially lower cost than Northwest sells gas, and passes the benefits on to its customers in lower rates to its customers.

As far as the point about Mr. Halvorsen made of three cases he is aware of bypass, these are three certificate cases in which the commission has addressed bypass on its merits. In Cascade's case we see a refusal now by the commission to look at the merits with the July 19th orders, the doors are open. Any customer, end user customer anywhere can find gas and have it moved, FERC is not going to look at it.

I have already gotten two brochures from the various companies that put on seminars announcing bypass seminars so as to educate folks on how they can take advantage of these orders. There will be many more cases of bypass. Cascade is already aware of a few more brewing on its system.

Senator FOWLER. Mr. Bush, in your written statement you emphasize that the gas transportation rate from Texas to New York on Transco's system is about 60 cents. For example, you use while transportation rates after the gas enters the LDC distribution system, sometime is $2, why is there such disparity and is there, in your opinion, a major difference in the way FERC determines interstate rates from the rate making of the State commission?

Mr. BUSH. No. Let me point out what we are coming to grips with and trying to and in some cases many producers, many industrial users are in lawsuits over this very issue.

Senator FOWLER. Take the first part first. In the example that you use, why is there such disparity?

Mr. BUSH. It varies. In some cases that the LDC is successful in convincing the PUC that the fixed costs for that service that is provided to that industrial user, the transportation rate is worth $2. And that is what I meant in my testimony about how this is such a mixed bag when you get among certain States.

Each State public utilities commission depending upon its own ability to analyze, its own sophistication with the gas business itself, which is a highly complex and a very sophisticated set of issues that you have to be looking at. A lot of State commissions do not focus primarily on gas. They focus on telephone, water. They do not primarily focus on gas as an issue.

And so when they take up these transportation rates and an LDC pleads to put forward a transportation rate that would hold an industrial consumer to this kind of a transportation rate and feels it can get it, then it does so. And in some cases it jeopardizes, we feel now, the fact that, in fact, a State like Virginia, which can put in an 18 cent transportation rate can feel that it needs and wants to attract industrial customers into the State on that basis.

It is largely an ability of the State public utility commission to analyze the costs of the LDC and whether or not it recognizes the interstate implications. That is a problem. If you look at this on a State-by-State basis, there are interstate implications.

The other point, if I can make just two other points on that question, I want to correct this representation that I was talking about an LDC bypass being conversion rights. I am not talking about the conversions rights under 436. I am talking about separate facilities being built to bypass a pipeline.

So, conversion is a whole different thing. Buying spot gas—that is a different problem that is created. I am talking about separate facilities that are being built and by being bypassed in that instance. And I think the witness from Cascade has been very honest today. He said that these bills would prevent future bypasses. That wipes out any question that—of the intent of this legislation. I think that is a very honest reply.

And I think the second answer is that they would seek the least cost use, and again, I come back to our statement is honing in on that is the world right now. Everybody is looking for the least cost use, and it ought to be that everybody has that opportunity, and we should not insulate this kind of thing.

This thing about industrial users, you know, they are our biggest market, Senator. The residential market is about 25 percent of our market. It cannot drive the market. It cannot support this market, and that is what we have got to retain.

Senator FOWLER. Mr. Halvorsen, in your statement you were very explicit in wanting, as I heard you, wanting FERC to, as you said, continue to address and resolve these issues. And in your written statement, you very firmly and straightforwardly suggest that FERC determine if a bypass is in the public interests after taking into account all consumers.

Who protects in your opinion residential consumers from States who maybe cannot afford legal counsel at FERC? Is there any protection under the NGPA under section 31?

Mr. HALVORSEN. Mr. Chairman, we believe that FERC has the responsibility and the authority to do that.

Senator FOWLER. Wherein lies that authority?

Mr. HALVORSEN. The Natural Gas Act of 1938 gives the commission authority basically in all cases to protect the public interest and look at what is best for the consumer.

Senator FOWLER. And in your opinion, as you reviewed the policy, obviously, you think that is adequately—you have no criticism that that—that those residential consumers are not being protected in your opinion?

Mr. HALVORSEN. We believe they are, yes.

Senator FOWLER. Let me just follow up. How does pipeline A solve the problem of lost customers and lost revenues when pipeline B bypasses pipeline A's traditional LDC suppliers?

Mr. HALVORSEN. Basically the wide open market. It is a new world for the pipelines, and we are all competing with one another. It is the best man wins, so to speak. It is whichever pipeline can provide the most competitive service. That is the pipeline that is going to prove that service.

Senator FOWLER. Sometimes you win and sometimes you lose?

Mr. HALVORSEN. That is correct.

Senator FOWLER. Gentlemen, thank you. We could go on, but in the interest of a full room and a full witness schedule, we had better get to the next panel.

Thank you all for your testimony.

Our next panel of witnesses that I shall invite to this table at this time, Dr. Mark Cooper of the Consumer Federation of America; Mr. Willis Noland, the President of the Powell Group in Lake Charles, Louisiana; Mr. Jim Porter, Vice President of GDC Engineering, Incorporated of Baton Rouge, Louisiana; Mr. Joseph R. Dudak, Energy Manager of the National Steel Corporation in Pittsburgh, representing the Process Gas Consumers Group.

Gentlemen, you all know the rules we are trying to abide by, and your testimonies will be submitted thoroughly. If you can summarize and I will try to hold you to those few minutes so that we can have more time for questioning and discussion. Dr. Mark Cooper of the Consumer Federation of America.

STATEMENT OF DR. MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA, ON BEHALF OF THE CITIZEN/LABOR ENERGY COALITION

Dr. Cooper. Thank you, Mr. Chairman. My name is Dr. Mark Cooper. I appear today presenting joint testimony from the Consumer Federation and the Citizen/Labor Energy Coalition.

And I must say that in preparing joint testimony between two groups such as ours, we work out every word carefully and try and change as few as possible. And I owe you a corrected copy which changes the bill numbers from the House side. We pulled the wrong one off the computer.

Senator Fowler. It is one of the few things we might be able to handle.

Dr. Cooper. Thank you. Your letter inviting me to testify poses four questions, and I thought I would briefly ask and answer those questions.

The first question is, do you support enactment of legislation and why? Yes, we do, because we believe that the state is where the decision about bypass should be made. The consequences of bypass are essentially local decisions, they affect local people and businesses, and it is Federal policy to defer to the states on such issues.

The problem we currently face is that the Federal Energy Regulatory Commission does not engage in a public interest test to estimate the costs and benefits of a potential bypass in a coherent manner.

The current policy is simply to allow the bypass to happen. If the bypasser wins it will be approved, and as you have heard FERC is not even going to look very carefully anymore.

If there are losers in those cases where it has looked, FERC will leave the states to clean up the mess from the bypass decision.

The regulatory competition created in this approach is fundamentally unbalanced, unfair to residential and small commercial ratepayers, and violates basic tenets of Federal-State relations.

Potential bypassers frequently come before State public utility commissions and ask for a change in the rate structure. If they do not like the outcome, they are now encouraged to run to FERC and retry those issues.

But the State residential and commercial ratepayers have a much smaller voice at the Federal Energy Regulatory Commission. In essence, we have a regulatory competition in which the large industrial users can try it once at the state level and then run to the Federal level if they want a second chance.

The second question, would bypass legislation affect the movement to a market-based natural gas market? We believe that it would assure a fair and balanced approach to market transactions.

The logic of allowing FERC to not look essentially at bypass decisions, to simply let them happen, which is their current approach, is clear when one observes that a significant part of the impetus to bypass has been created by FERC's inability to clean up the natural gas market.

Local distribution companies, as you have heard, are bound to pipelines, in high-cost historical transactions. And FERC has not found a way to free them from those obligations. Yet, it turns around and lets pipelines offer lower-priced deals which will bypass the LDC.

In essence FERC has freed the pipelines to do the best they can, but not freed the LDC's to do the best they can. And remember, in this case the LDC is the primary agent of the residential customer who has absolutely no alternative.

Mr. Bush talks about letting all customers have alternatives. The residential customer does not. Therefore, the residential ratepayer will be the big loser from bypass. They are overwhelmingly the customers left behind.

FERC and bypassers may close their eyes to the costs that are left behind, but it is the local ratepayers, the residential ratepayer, and perhaps LDC stockholders who will end up fighting about those costs. And we fear that the residentials will frequently lose.

The third question, you asked me to summarize our analysis presented in a report from February of last year. The essential conclusion of that document is a two-pronged public interest test which we would like to see applied to the question of bypass. One is a simple cost of bypass test. The second is a total systems cost test.

In essence, a bypass ought not be approved unless it can demonstrate that the cost of serving the bypasser is less than the potential cost of serving that same customer by the LDC. That is obvious.

Second of all, however, there is a public interest aspect. The total costs of serving all customers from the bypass ought to go down as a result of the bypass. That is real efficiency. If we lower the cost of serving everybody, not just simply shifting the costs around.

Obviously there may be cases in which, and we think that is the overwhelming majority of cases, in which the bypasser wins but everybody else loses. That is the reality. There are costs that have to be recovered.

We think that public service commissions should be allowed to make a price offer to the potential bypassers. And as we understand it, the overwhelming majority of public service commissions have become much more willing to do so. And that is essentially what the legislation before you compels.

It says that where the bypasser could win but other customers will lose, a negotiation takes place. Not a blackmail, which is what we now have, but a negotiation, in which the local distribution company and the bypassers before a regulatory commission which is willing to look at the issue work out a deal, which allows the benefits perhaps to be increased to the bypasser but not to leave all of the costs with the local distribution company or the stockholders.

The fourth question you asked was, have things happened since February to lead us to change our conclusions?

Mr. Chairman, the rule that we proposed which is known as an equal benefits rule for allocating costs in mixed use or mixed market type of facilities has been known for 50 years. It was in fact applied to some of the large multi-use facilities constructed by the TVA.

It is an economically sound rule, it is economically efficient, and it is equitable. Nothing that has occurred in the past six months has led us to abandon this long-term, sound, tried, and true principle.

In conclusion, we believe that the Federal Energy Regulatory Commission has shown absolutely no inclination to approach the bypass issue with anything but a blind ideological commitment to competition at all costs, even when competition does great harm to those consumers who have no real competitive alternatives.

As a matter of principle, FERC should not be the locus of this essentially local or state decision. And as a matter of practice, it has failed to show itself worthy of that decision. Thank you.

[The prepared statement of Dr. Cooper follows:]

JOINT TESTIMONY OF

THE CONSUMER FEDERATION OF AMERICA

AND

THE CITIZEN/LABOR ENERGY COALITION

on

BYPASS OF NATURAL GAS LOCAL DISTRIBUTION COMPANIES

before the

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

of the

COMMITTEE ON ENERGY AND NATURAL RESOURCES,

UNITED STATES SENATE

SEPTEMBER 29, 1988

SUMMARY

We believe that the state is where the decision about bypass should be made because the consequences of bypass decisions are local, the people and businesses affected are local, and it is federal policy to defer to the states on issues which so clearly affect them.

The problem we currently face is that the Federal Energy Regulatory Commission (FERC) does not engage in a public interest cost/benefit estimation in any coherent manner. The current policy at FERC is that as long as the bypasser wins, it will approve the bypass. It will not calculate or even consider who the losers are or how much they lose. If there are losers, FERC leaves the states to deal with the problem by allocating losses between stockholders and the remaining consumers.

The regulatory competition created is fundamentally unbalanced, unfair to residential and small commercial ratepayers, and violates the basic tenets of federal/state relations. Potential bypassers frequently come before state public utility commissions requesting rate structure changes. If they do not like the outcome of the state process, they are encouraged to run to FERC and ask for bypass. Residential and commercial ratepayers, who have virtually no opportunity to bypass and whose interests are weighed at the state level, are excluded from the federal process. The regulatory competition which FERC has established gives potential bypassers immense leverage against the other affected interests.

The illogic of allowing FERC to make the bypass decision and stick the states with the problem of cleaning up the mess is even clearer when one observes that a significant part of the incentive to bypass has been created by FERC's failure to deal with the disorder in the natural gas market. Local distribution companies (LDCs) are bound to pipelines in historical, high cost transactions. FERC has not found a way to free them from those relationships. Yet, it will allow pipelines to offer lower priced deals to the LDCs' most lucrative customers. In essence, FERC has freed the pipelines to cream-skim against the LDCs who it has not effectively freed.

Residential ratepayers will be the big losers from bypass. They are overwhelmingly the customers left behind by the bypasser. Bypassers and FERC may close their eyes to reality, but when costs are shifted from bypassers, all remaining local interests will suffer and residential consumers are likely to suffer most. FERC has shown the way in this regard, protecting pipelines and large end-users, while sticking it to firm, captive customers under the banner of increasing competition.

Only by vesting the primary decisionmaking responsibility in the state commissions, where all interests are represented and balanced, can a fair outcome be achieved. Congress must act, quickly and effectively, before the local distribution network is cherry-picked apart, leaving small captive consumers to foot the bill.

Mr. Chairman and Members of the Committee,

My name is Dr. Mark N. Cooper. I am Director of Research of the Consumer Federation of America. I am accompanied by Edwin Rothchild, Assistant Executive Director of the Citizen/Labor Energy Coalition.

Our two organizations represent hundreds of state and local consumer, citizen action, labor, farm, senior citizen, and low income groups with tens of millions of members. Our members are active in the regulatory arena at both the federal and state levels.

I am delighted to be here today to present our joint testimony on the proper roles for the state Public Utility Commissions (PUCs) and the Federal Energy Regulatory Commission (FERC) in evaluating the bypass of natural gas local distribution companies.

THE STATE IS WHERE THE BYPASS DETERMINATION SHOULD BE MADE

There are several bills before the House of Representatives (H.R. 4089, The Natural Gas Transition Act of 1988; H.R 3445, The Natural Gas Consumer Protection Act of 1987) which would place the authority to make bypass decisions and the responsibility for dealing with the consequences of those decisions in the hands of state public service commissions. We believe that the state is where the decision about bypass should be made because

> the consequences of bypass decisions are local,
>
> the people and businesses affected are local, and
>
> it is federal policy to defer to the states on issues which so clearly affect them.

The first two points are overwhelmingly clear and have been conceded by the Federal Energy Regulatory Commission; the last point was reiterated on October 26, 1987, when President Reagan issued Executive Order 12612, which clearly set out the distinction between the role of the federal government and the role of the state governments. In addressing criteria for federal policymaking, President Reagan stated,

> It is important to recognize the distinction between problems of national scope (which may justify Federal action) and problems that are merely common to the States (which will not justify Federal action because individual States, acting individually or together, can effectively deal with them).

Bypass is such a problem. It is not national. It is local. Each state must have the power to deal with the problem as local conditions and circumstances warrant. Since the FERC has decided not to defer to the state PUCs, legislation is required to curb the Commission's power in this regard.

In order to appreciate the growing urgency for Congress to enact legislation in this area, it is important to appreciate both the likely impact of bypass and the context within which FERC is making bypass decisions.

A REALISTIC APPRAISAL OF BYPASS IMPACTS

In the best of all possible worlds there would be no losers from bypass. The bypassers will win and nobody else will lose. Clearly, no regulator would oppose such a bypass.

> Unfortunately, such happy situations are likely to be extremely rare -- like perpetual motion machines in frictionless outer space, or contestable markets typified by frictionless entry and exit.

The real world outcome is much more likely to be that the bypasser will be better off and someone else (the remaining customers and/or LDC stockholders) will be worse off. There are two possible orders of magnitude of winnings and losses.

> If the bypassers win more than everyone else loses, there is an efficiency justification for the bypass, although the equities must still be worked out.
>
> If the bypassers win less than everyone else loses, the bypass is destructive and should be disapproved.

Because the real world outcome is overwhelmingly likely to be ambiguous -- to require estimating and balancing winnings and losses -- one would expect that the regulatory body with responsibility for deciding whether or not to allow bypass would have a clearly articulated approach to balancing costs and benefits. That is absolutely not the case.

The problem we currently face is that the Federal Energy Regulatory Commission (FERC) does not engage in a public interest cost/benefit estimation in any coherent manner.

> The current policy at FERC is that as long as the bypasser wins, it will approve the bypass.
>
> It will not calculate or even consider who the losers are or how much they lose.
>
> If there are losers, FERC leaves the states to deal with the problem by allocating losses between stockholders and the remaining consumers.

As a matter of principle, we believe that if the states are going to be left with the nasty task of cleaning up FERC's mess, they ought to have the primary role in deciding whether the mess gets created in the first place.

Even as a matter of regulatory effectiveness and economic efficiency, the states should be the locus of the decision. When one analyzes the potential efficiency gains from the threat of bypass which have been emphasized by some economists and by bypassers in their applications, one finds that almost invariably they require actions at the state level.

> There are very few instances in which pure efficiency gains -- like opening new gas supplies by adding transportation capacity -- will take place in the federal jurisdiction. The most frequently asserted benefits require state regulators to alter their rate structure to achieve a better fit between supply and demand or to squeeze the profits of local distribution companies so that stockholders pressure management to squeeze out inefficiencies.

If the states are expected to be the creators of benefits by responding to threats of bypass and the allocators of costs in the event of actual bypass, then they should certainly be the bypass decisionmaker.

PARTIAL COMPETITION, MONOPOLY & REGULATION

The illogic of allowing FERC to make the bypass decision and stick the states with the problem of cleaning up the mess is even clearer when one observes that a significant part of the incentive to bypass has been created by FERC's failure to deal with the disorder in the natural gas market.

Under current conditions there is a distinct possibility that bypass represents a price squeeze and cherry-picking by pipelines against local distribution companies. Local distribution companies (LDCs) are bound to pipelines in historical, high cost transactions; FERC has not found a way to free them from those relationships. Yet, it will allow pipelines to offer lower priced deals to the LDCs' most lucrative customers. In essence, FERC has freed the pipelines to cream-skim against the LDCs who it has not effectively freed.

The Federal Energy Regulatory Commission has changed the "rules of the game." Above all else, the FERC believes that it has no obligation to protect residential, small commercial and other captive consumers. This is the function, says the FERC, of state public utility commissions. Thus, the FERC has adopted rules and regulations which either impose large costs on or limit the options available to these categories of end-users.

The Federal Energy Regulatory Commission has systematically pursued policies designed to end the regulatory compact that once existed among producers, pipelines, distributors and consumers. Gone is the commitment "to protect consumers from exploitation by natural gas companies." In its place are Order 451, Order 436, and Order 500. In its place are

> rules providing for higher old natural gas prices,
>
> decisions protecting high-cost producer-pipeline contracts,
>
> rules to force firm customers to bear a large part of the cost of pipeline take-or-pay provisions, and
>
> an overall FERC attitude of serving the economic interests of large interstate pipelines, large producers and large end-users.

From the beginning of the 1980s, when consumers began to rebel against high prices and imprudent pipeline gas purchases, creating a crisis for gas pipelines and producers, the FERC was there to provide a comfortable safety net. First it was Special Marketing Programs -- a great deal if you happened to be a large industrial customer, a pipeline with take-or-pay problems or a producer unable to move gas. There was only one problem. It was discriminatory and violated the law.

Dragged kicking and screaming into the courts by the Maryland Peoples' Counsel, the FERC then proposed Order 436. While certainly an improvement over the SMPs and other programs, it still failed to address the most burning issue -- the failure of pipelines and producers to renegotiate their high cost and high take-or-pay contracts.

> Even Order 436 did not make it easy for Local Gas Distribution Companies to obtain competitively priced gas for the benefit of all their customers.

In fact, Order 436 basically made some cheaper gas available to LDCs, but, more often than not, solely for the purpose of helping the LDC retain industrial load rather than reduce prices to residential, commercial and other consumers.

> Under Order 436 an LDC could not greatly alter its contract demand quantities and was still left a captive of its pipeline supplier.
>
> And, of course, industrial customers, who had

> helped create the take-or-pay problem by switching from gas to oil, became the greatest beneficiaries because they obtained access to low cost gas and access to transportation.

Order 500, while an improvement over Order 436, still

> allows pipelines to pass onto their customers, and thus onto residential and other firm consumers, 50 percent of take-or-pay costs,
>
> set out guidelines for a "gas inventory charge" which is another device designed to shift market risk from pipeline shareholders to firm customers, and
>
> made it more difficult for LDCs to obtain increased access to the gas market by eliminating contract reduction rights.

As interstate pipelines have become subject to open access provisions, more and more gas has flowed under transportation arrangements. But the greatest beneficiaries of transportation are large industrial and electric utility gas consumers. This is because most, if not all, of the transportation available on pipelines is interruptible capacity. While LDCs can use this capacity to transport gas during the summer months for storage for resale to residential customers, the price changes that have occurred support the view that residential customers have obtained only a small portion of the benefit of lower priced gas. This is because residential consumers must continue to pay for (because their LDC suppliers continue to purchase) gas supplies that still exceed competitive levels.

Gas flowing under sections 102, 103, 107, 108 and 109 is still priced significantly above market levels. This gas is not being purchased by large industrial customers. Thus, the greatest price reductions have occurred for those customers with the largest number of competitive options -- industrial and electric utility boiler fuel users.

Clearly, the changes that have taken place have provided significant price reductions to customers with competitive options. On the other hand, residential consumers have received limited benefits, because they have few competitive alternatives. LDCs, restricted by FERC rules regarding the pass-through of take-or-pay costs, the repricing of old gas, the prohibition against contract demand reduction, and faced with pressure from their largest customers for competitively-priced fuel, have shifted these costs to those customers with no alternatives.

Bypass of LDCs would only exacerbate the competitive disadvantage faced by captive consumers. Residential ratepayers will be the big losers from bypass. They are overwhelmingly the customers left behind by the bypasser. Bypassers and FERC may close their eyes to reality, but when costs are shifted from bypassers, all remaining local interests will suffer and residential consumers are likely to suffer most. FERC has shown the way in this regard, protecting pipelines and large end-users, while sticking it to firm, captive customers under the banner of increasing competition.

RESTORING THE REGULATORY BALANCE

The current approach, where the federal authority creates winners and the state authority deals with losers is contradictory to the basic tenets of federal/state relations. The regulatory competition created is fundamentally unbalanced and unfair to residential and small commercial ratepayers.

Potential bypassers frequently come before state public utility commissions requesting rate structure changes. If they do not like the outcome of the state process, they are encouraged to run to FERC and ask for bypass.

- As long as they show FERC that they will be better off, FERC will approve the bypass.

- Residential and commercial ratepayers, who have virtually no opportunity to bypass and whose interests are weighed at the state level, are excluded from the federal process.

> The regulatory competition which FERC has established gives potential bypassers immense leverage against the other affected interests.

Only by vesting the primary decisionmaking responsibility in the state commissions, where all interests are represented and balanced, can a fair outcome be achieved. The balance between federal and state jurisdictions which FERC's shortsighted bypass policy has upset to the detriment of residential and small commercial consumers must be restored. FERC has shown no inclination to do so. Therefore, Congress must act, quickly and effectively, before the local distribution network is cherry-picked apart, leaving small small consumers to foot the bill.

Senator **Fowler**. How about open access transportation, do you support that?

Dr. **Cooper**. Absolutely.

Senator **Fowler**. Mr. Willis Noland, President of the Powell Group, Lake Charles, Louisiana.

STATEMENT OF WILLIS NOLAND, PRESIDENT, THE POWELL GROUP

Mr. **Noland**. Thank you. I appreciate the opportunity to be here today and I appreciate you letting me put my statement in the record so I do not have to read it.

We are a fourth going on fifth generation family-owned company down in the the southwest corner of Louisiana. We have been producing natural gas for over 50 years. We hope we can continue doing it for the next 50 years.

This bypass legislation is real important to me. In the short run it sounds like a good thing, but in the long run I submit to you two things. It is going to concentrate the ability to purchase gas in the hands of a few and it is going to cause an upward spiral in rates to the consumer.

I hope that when you deliberate on this you will take that into consideration. My testimony is in the record. I appreciate the opportunity to be here today.

[The prepared statement of Mr. Noland follows:]

Statement of Willis Noland
President, The Powell Group
Lake Charles, Louisiana
before the
Committee on Energy and Natural Resources
September 29, 1988

Mr. Chairman and Members of the Panel:

Thank you for the opportunity to testify before you today on the subject of local gas distribution company bypass.

I'm the President of the Powell Group in Lake Charles, Louisiana. We are a fourth, with the fifth on the way, generation family-owned business. We have produced and marketed gas for fifty years and look forward to continuing to do so for the next fifty.

We are not currently drilling any gas wells because the price of well-head gas does not justify investment in new gas wells. What gas we are selling is sold either on the spot market or under very short form contracts in Louisiana and Texas.

It is no secret to this committee that producers have been hard hit by the decline in energy prices. Gas producers like me, who thought that we had contracts to sell gas on which we could rely, have discovered that those contracts are not worth the paper they are written on.

Natural gas producers, particularly small and independent producers like my company, do not have the resources to devote to marketing natural gas at the burner-tip. We have always depended on local distribution companies to develop the end use market for natural gas. That is changing now. The pipelines and the major oil companies have developed their own deregulated marketing operations. Many of these major oil and pipeline companies continue to believe that healthy local distribution companies are necessary to a healthy natural gas market. However, a steadily increasing number of these companies, lured by FERC policies that make cream skimming easy and attracted by the prospect of wellhead-to-burner-tip control over natural gas transactions, are bypassing local distribution companies. I think this bypass activity is bad for consumers and bad for producers.

Bypass Doesn't Increase the Size of the Gas Market

The most important factor affecting the natural gas market today is the large surplus overhanging the market. There is just too much gas and not enough demand. Bypass does not increase sales of natural gas. In fact, bypass, because it depends upon building duplicate facilities to serve the same customer may actually result in a smaller market in the long term.

The natural gas distribution and transportation system has larged fixed costs. This system, therefore, is most efficient (and gas prices are most competitive) when the system is fully utilized and the fixed costs are spread out over the largest possible volume of gas. When a pipeline bypasses an LDC, the LDC's fixed cost must be spread across a smaller number of customers. This increases the rates those customers must pay for the same amount of gas and encourages consumers to reduce their natural gas consumption or to switch fuels. When less gas is sold, there must be another increase in the cost of the natural gas service to remaining customers. The ultimate result will be a smaller natural gas market for producers unless this greater fixed cost burden is netted back to producers. In that case, producer revenues would be lower. I don't see how either prescription will be good for producers.

The problem of course is that construction of duplicate facilities increases the fixed costs of the system without any increase in the volume of gas actually moved through the system. Pipelines and distributors are entitled to recover from consumers the cost of constructing new facilities and gas must compete with other fuels at the burner tip. Therefore, the cost of duplicate facilities will be taken out of producers' pockets unless producers decide to shut in their gas as many are deciding to do right now. So the answer is to develop a natural gas policy which will result in a growing rather than a shrinking market for gas.

Bypass Can Increase Pipeline Monopoly Power

Many producers are served by only one pipeline buyer of natural gas. Without access to transportation, the producer has no other market. The pipeline-buyer can force a producer to choose between an unreasonably low price or shutting in his gas. Small and independent producers are most vulnerable to pipeline abuses because they have difficulty packaging and selling gas to buyers other than pipelines. With transportation, other potential buyers like LDCs can keep the pipelines honest. Producers can get a fair price for their gas and stay in business. If pipelines take market share from LDCs by bypassing them, LDCs will be less significant as alternative purchasers of gas from producers. Producers will be more at the mercy of pipelines, especially if that pipeline refuses to transport the producer's gas.

If an LDC knows that it may, at any time, lose a major customer to an interstate pipeline, that LDC will not enter into long-term supply arrangements to serve that customer. Fuel switchable industrial users served directly by pipelines generally have not entered into long-term firm contracts with producers. Consequently, bypass will reduce producer opportunities to sell gas on a long-term basis.

Conclusion

Mr. Chairman and members of the Committee, I believe the health of the natural gas industry depends on fair competition at all levels of the industry. LDC bypass will allow the pipelines to consolidate their monopoly positions, hurting producers, consumers and distributors of natural gas.

Congress must act to ensure that bypass, in the name of increased competition, does not merely increase pipeline monopoly power. Bypass should be prohibited if LDCs are willing to transport gas without discrimination on the basis of the source, ownership, or destination of the gas and are willing to transport gas at the cost of providing that service.

Senator **Fowler**. I thank you for your directness and the thoroughness of your testimony, Mr. Noland, very much.

Mr. Jim Porter, Vice President of GDC Engineering in Baton Rouge.

STATEMENT OF B. JIM PORTER, VICE PRESIDENT, GDC ENGINEERING

Mr. **Porter**. I appreciate the opportunity to be here today to speak to you.

I am former Secretary of the Department of Natural Resources for the State of Louisiana, and I emphasize former. I am not a State official at this point in time. I have been involved in energy regulation for the past 20 some odd years or so.

We in Louisiana are definitely a producing state. We are also a consuming state. And as a result of that, we have excess capacity, and we export a large amount of natural gas to other portions of this country.

It is from that standpoint that I am here concerned that we do not do anything that is going to in the long run be detrimental to our delivery system.

We have seen the Federal Energy Regulatory Commission deal with issues about bypass. We have seen them deal with issues that go into the gathering system. We are, in the State, have always been very concerned about anything that would interfere with our intrastate system.

If you see what is happening it is logical that this may be the next step. There is a lot of interplay between intrastate and interstate systems after the NGPA. And so I just want to make sure that those systems remain viable.

I have drawn a parallel in my formal presentation paper that is presented that talks about the REA. If we look earlier in this century, our country was developing, it was easy for us to get power delivered to major metropolitan areas.

But when it came to the issue of trying to serve those rural customers, the marginal ones, we had to develop a system with Federal support to provide that power to those individuals in those small areas.

We have got a system in place now that the private sector has put there, and we do not want to see something happen to that that would allow the larger industrial users to get those good prices but then put pressures on the delivery system for those others.

Now in Louisiana we have a competitive system, we have an intrastate system. We are setting on natural gas, it is right in our backyard. Our system has developed somewhat different than it has developed in other states.

But we are dealing with bypass issues that are just now coming before our public service commission. And this is where small distribution systems are losing, primarily educational institutions, and that is an issue that has now come to the forefront. Industry, the large industry, is served by that intrastate system, so it has not been that much of an issue.

I, when I was Secretary, was trying to deliver royalty gas, state-owned royalty gas that we would actually take possession of and move that to educational institutions within our state.

And that is when I first realized about the impact that that can have, when you have a distribution system and you are removing a large customer that it has, what happens with regard to the base for those other users.

Senator **Fowler**. Does your agency set rates?

Mr. **Porter**. Our agency has the power to set rates, but it has not set rates.

Senator **Fowler**. Since the sitings?

Mr. **Porter**. Yes.

Senator **Fowler**. Construction and environmental siting, but you have the authority to set rates but you have not? Why?

Mr. **Porter**. They have not seen it necessary. It has been able to stay competitive the way it is.

Senator **Fowler**. Continue. I am sorry.

Mr. **Porter**. So basically, with the issue I was talking about where the royalty gas was going, the impact I was wanting to make was the impact it would have on those distribution systems.

We would just ask that Congress look at this issue, make sure that these systems remain healthy, because we feel like there are some important things. I heard someone up at the table earlier say that the goal to this is to reduce the net back to the wellhead.

Well, if you are a producing State I do not really know exactly what that means. In some view it seems to me like it ends up that this producer here is going to end up possibly not getting what he would have gotten otherwise.

Whatever the case is, we have got a problem with deliverability of natural gas. We have got a problem of exploring for natural gas and maintaining our supply. And I would like to see this whole system work and we not get in another situation where we have got a delivery system that is messed up and we have people coming off the system and we know it is very difficult to get them back on.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Porter follows:]

STATEMENT OF

B. JIM PORTER

BEFORE THE

SUBCOMMITTEE ON ENERGY
REGULATION AND CONSERVATION

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

SEPTEMBER 29, 1988

Mr. Chairman and members of the Committee, thank you for allowing me to appear here before you today to discuss something which I believe amounts to surgery on a patient that is not ill; that is, the bypass operation that FERC has proposed for the natural gas industry and their consumers. Just as any non-essential surgery is dangerous because it exposes the patient to completely unwarranted and unnecessary risks, so is the Federal Energy Regulatory Commission policy towards bypass dangerous. And one of the serious risks of this operation is the FERC'S impingement on important state rights; rights that the United States Supreme Court has affirmed and reaffirmed.

The Bypass policy of FERC raises a number of very important issues which must be addressed. First, what effect will the interstate pipeline authority to bypass Local Distribution Companies have on those Local Distribution Centers? Secondly, what will happen to the long term security and price of natural gas to consumers when bypass limits customers to one supply source instead of multiple supply sources available through an integrated system? Thirdly, (and of great concern to me having been a former regulator) what will this bypass policy do to a state's authority to regulate in a manner that is most beneficial to the gas consumers?

I have some twenty years service with a state agency that regulates energy in Louisiana. For the past three and a half years I had the privilege of serving as Secretary of the Louisiana Department of Natural Resources which houses the Office of Conservation which is responsible for establishing natural gas conservation policies for Louisiana, including the intrastate transportation and sale of natural gas. The Office of Conservation assumed regulatory authority over intrastate pipelines in 1973. The intrastate system then consisted of 3,900 miles of main lines owned and operated by 13 companies. In 1985, it had expanded to 6,900 miles of main lines and 84 companies.

Intrastate pipeline companies deliver some 85% of the natural gas in Louisiana. Bridgeline, the largest intrastate system capacity-wise, and a very intricate system of lines, was delivering 1.5 bcf per day as of June of this year. Now, who is better able to determine the economic impacts on local communities of such a complex system. as Bridgeline: the state or someone in Washington?

For the last several decades, Congress has not only recognized, but insisted that the states take an active role in regulating the provision of natural gas service to the citizens of those states. The bypass issue is an integral part of any regulatory system which is promulgated to insure that all gas customers are getting reliable and fair treatment. It is for this reason that the United States Supreme Court held that Interstate pipeline companies did not have "a right to compete for the cream of the volume business without regard to the public convenience and necessity." And what makes FERC'S actions even more curious with regard to the jurisdictional question, is the present administration policies over the last several years with regard to federal de-regulation and state assumption of responsibilities and programs.

During my last year as Secretary of the Department of Natural Resources I was honored to serve and co-chair the Governor's Task Force on Natural Gas in Louisiana. Many experts from the natural gas industry served on that task force. and we studied and evaluated almost every single aspect of the natural gas industry. One of the most important things I came away with from our efforts was that federal regulation does not lend itself to a more open, competitive and market-responsive natural gas industry. For example, Mr. Chairman, the absolute worst period in Louisiana's natural gas history (which is a long one) came after the 1954 Phillips decision which ushered in wellhead price controls which, over thirty years later, we're still trying to untangle as a result of excess and oftentimes heavy handed federal regulations.

For the record, I would like to say that we have, with FERC'S help, made substantial and significant progress over the last few years. Consumers all across the U. S. have benefitted from the near sanity that has been injected into the process. Then, all of a sudden, beginning in 1986 with the case involving Mobile Gas Service Company, without apparent concern for a constructive regulatory system, comes FERC'S granting of a certificate to construct a new facility that would bypass a local distributor. The Mobile case was followed by other bypass approvals including one for a company in Michigan. What's frightening about the Michigan decision is FERC'S attitude towards state rights, authorities and jurisdictions. I think it's important for me to quote for you the Commission's decision:

> In recent years we have developed a regulatory policy designed to encourage pipelines to offer ready access to interstate transportation to also create competition for wellhead prices. State commissions remain free to regulate the rates and review the purchasing practices of distributors under the jurisdiction. If State commissions had authority to frustrate individual pipeline transactions like this one, however, they could seriously affect our ability to foster the development of an economically efficient system of interstate transportation.
>
> In other words, irrespective of any local effects resulting from the by-pass, we believe that the transportation service at issue here essentially concerns Federal interests, that is, those embodied in developing interstate transportation policy that provides consumers with a variety of supply options by promoting a competitively priced spot market for natural gas. (Emphasis added)

So what we fear from this decision is the real threat that FERC will overturn that delicate regulatory balance that has resulted from the Natural

Gas Act and (without legislative guidance) develop new policy and regulation through piecemeal administrative determinations.

This conclusion is further illustrated by the Commission's findings in two orders approved June 15th (Northwest Pipeline Corporation Docket No. RP-56-020 and Northern Natural Gas Company - Docket RP 85-206-036 and RP 85-206-039). In the Northern case, the Commission held that it even had jurisdiction over the rates charged for gathering services. The following is a quote from the Northern case:

> The Commission continues to believe it unnecessary to reach the issue whether Northern's service here at issue is gathering, as that term is used in NGA Section 1(b). Even assuming that Northern's service is gathering, the Commission has jurisdiction to determine the justness and reasonableness of the rates, terms and conditions under which the gathering service is performed.

Mr Chairman, I hope you can appreciate my position on this issue. It's not because Panhandle Eastern got something they might shouldn't have had, nor is it because Northern and Northwest was denied something they might should have had. It's because in January of 1988 I see FERC saying "We have jurisdiction of transportation services irrespective of any local effects." Then six months later, in June, I see FERC saying "Oh, by the way, we also have jurisdiction to determine the justness and reasonableness of the rates, terms and conditions under which gathering services are performed." Mr. Chairman, I wonder what's going to happen next Will it be "Oh, by the way states, we also have jurisdiction over regulation of intrastate pipelines because we want to promote increased competition in Louisiana." According to FERC'S recent reading of its authority this is not at all a farfetched assumption.

Let me draw you a parallel which I think will better help you to understand my position on the bypass issue. Earlier this century, this country was experiencing tremendous growth and we were fast becoming a nation of energy consumers. Everyone wanted electric utilities for the convenience and "better life" that it afforded. Providing this service in urban areas was little or no problem. However, when it came time to provide electric service to sparsely populated rural areas with its low load demands and expensive to serve customers, the utility companies balked because of the economics. As such, the federal government was forced to create the Rural Electric Authority (REA) which subsidized the distribution of electrical utilities to those hard to service customers. This particular federal involvement worked well because it actually subsidized the creation of an infra-structure that still exists today. The natural gas distribution system, on the other hand, was created and paid for by the natural gas market. There has been no need for federal subsidy to this point in time. The reason I say "to this point in time" is based on my belief that with bypass this distribution system or "package" will unravel. Customers which, because of their specific loads and usage characteristics are able to strike marginally better arrangements with alternative suppliers will simply leave the system. As a result, with each such departure, the quality of the remaining "package" deteriorates, with the consequence that service to the remaining customers increasingly becomes less secure and higher priced. No longer is the utility able to achieve the greatest good for the greatest number; rather, different types of customers in different areas of the state begin to gain significant advantages over others less fortuitously positioned. Once this has occurred, the entire infrastructure breaks down and FERC (or some other federal agency) will then have the arduous task of subsidizing the re-creation of an entire natural gas distribution system in this country.

In conclusion Mr. Chairman, I believe in a strong role for the states, but if states are to continue to have the responsibility for establishing policies to protect its gas resources and its consumers, then it must retain the tools to be able to do so. FERC is intent on denying the states that ability in what amounts to Regulatory Imperialism. So I am here today simply to ask for a second opinion. Prior to letting FERC do its Bypass Surgery, please let Congress at least look at the symptoms (if any) and if it "ain't sick don't let FERC doctor it." Thank you.

Senator **Fowler**. Thank you very much. Mr. Joseph Dudak, Energy Manager of National Steel Corporation, representing today the Process Gas Consumers Group. Welcome, Mr. Dudak.

STATEMENT OF JOSEPH R. DUDAK, ENERGY MANAGER, NATIONAL STEEL CORP.

Mr. **Dudak**. Good morning, Mr. Chairman, and thank you, and Members of the Subcommittee.

I am Joseph Dudak, the Director of Energy for National Steel Corporation. I am also a member of the American Iron and Steel Institute and the Process Gas Consumers Group.

My testimony today also has the support of the Aluminum Association, the American Paper Institute, Chemical Manufacturers Association, and the Petrochemical Energy Group, as well as a group of 24 large and small industrial end users in Georgia. And I would like to submit their list also to the record today.

Senator **Fowler**. I had better let that in.

Mr. **Dudak**. National Steel is also the company that is currently flowing gas today through both its LDC and through a FERC-approved direct hookup with Panhandle Eastern that was authorized by the Federal Energy Regulatory Commission in September of last year.

Today I would like to urge you for the sake of all American industry and all the ratepayers not to pass Senate bill 1998 or 2313, or any such similar bill.

If this would occur I would have to say for National Steel that the approximate 20 to 30 BCF of Louisiana gas that I buy today would most probably have to be shifted to Canadian sources.

My brief remarks today, though, will address some of the myths that proponents of the bill associate with bypass. But before I do I would like to briefly state why this is of some importance to all of your constituents.

American industry, as my prior panel of speakers have said, is competing in a global market today where prices are set by the market and not by the cost of production. In order to survive industry, in large industry and small industries, have begun managing their businesses with new and aggressive management philosophies.

The restructuring that is going on in American industry today is now reliant on that new risk-taking and that innovative approach to old problems. We have had to adapt and force this adaption, and the same type of pressures that we are undergoing, to all the components of our cost. That is to our labor, to our management, to our raw materials, and to everything else we purchase.

We have learned to do so in the natural gas marketplace in the last two years, and the continuation of this evolution in the natural gas industry is a very vital part of our ultimate survival.

Part of that evolution is the discipline that is just beginning recently, with the threat of bypass in the competitive marketplace. That is an important concept today.

Maintaining the threat of bypass maintains competition in a previously bullet-proof area of utility monopoly as one of the components of the natural gas marketplace. To American industry, energy is a big part of their cost of doing business.

In the steel industry, it is 25 percent of our cost of doing business. But to those others, who are supporting my testimony today, it is much more than 25 percent.

One of the ironies——

Senator **Fowler**. Excuse me. Does that argument apply both ways, in your opinion? The threat of bypass from the industrial user around and also in LDC bypassing for cheaper gas somewhere else?

Mr. **Dudak**. Yes. I believe it applies both ways.

Senator **Fowler**. You think that argument that you just made, that that maintains a healthy competitive environment, viewed from both sides?

Mr. **Dudak**. I do maintain that. And I will speak later to the fact that the LDC that we had our approval to go around with Panhandle is currently doing a bypass. Even though they are arguing against ours.

Several of the facts today around the bypass issue are brutal facts.

Senator **Fowler**. Please forgive me. In that case that you just mentioned, did you try to negotiate a lower rate from MichCon?

Mr. **Dudak**. From the day one that——

Senator **Fowler**. And what happened?

Mr. **Dudak**. I went to MichCon to request help in 1983, I asked them to help us transport gas or to lower the cost of our gas at that time, which was about $5.70 an MCF.

Their first response was that they would rip our meters out as soon as any alternative source of energy was brought into the plant. And they said they did not need us, and they would gladly rip out the meters.

We have tried all along the process, at each phase of each one of our pursuits. And there is a multi-phased pursuit of alternatives. We have asked MichCon to negotiate with us.

We had asked the commission in Michigan in 1984 to issue guidance and rules on transportation. It is now four years later and not one word on guidance, on rules, on regulations for transportation has been furthered by that commission. Not one.

Senator **Fowler**. Continue.

Mr. **Dudak**. I wanted to bring up a couple of the ironic and inequitable facts that surround the bypass issue today, and I call them brutal facts.

Industrial rates are admittedly, and Michigan is one State that admits that they are out of line with the concept of cost of service, but it is a broadly accepted practice, not only in Michigan but in several other States that industrial rates remain out of line.

Some State PUC's protect the monopolies rather than their consumers, and I think that is the issue today. The Michigan Public Service Commission, the State that I am discussing here, has allowed MichCon over the last four years to earn approximately 20 percent return on their equity versus the 14.9 that was previously approved for them.

I think it is a good example of how the State interests were taken into account at the disadvantage of many of the customers.

While those LDC's were receiving that type of excess return, their customers such as National Steel were struggling to survive. We have just last year begun to get our head above water as far as making profits. But the PUC's have shielded those LDC's from the realities of the same pressures that we have to face every day and that other components of the gas industry do follow already.

I would like get into the myths that I was talking about, and these are the myths that are advanced by the proponents of this bill.

The first myth is that residential rates will go up. The reality of that myth is that each case must be looked at for its unique facts at the public service commissions in those states. The LDC stockholders are also a key element in that equation and cannot be ignored and should not be given priority to maintaining their returns over the stockholders of large industries.

The threat of bypass, for instance, in Indiana between Bethlehem Steel and NIPSCO was enough to cause a settlement in that case which benefited all consumers, including residentials. Rates have gone down for all customers in that state just because the threat of bypass was there. No bypass occurred.

There is an exaggerated cry by the LDC's that the marketplace is going to be a disastrous place if bypass continues to remain a threat, but I believe that just as similar threats have been made at the onset of deregulation, the Natural Gas Policy Act, that, in fact, has not happened.

But the cry that I bring to you today is that without the threat of bypass and the competitive pressures, the LDC's will remain bulletproof and shielded by the public service commissions in those states from real world forces that we all face today.

The second myth is that this legislation is needed to preserve states' rights or the authority of the state commissions. The reality is that legislation is not their need. A change in philosophy and an open mindedness to reality is more their need.

The state public utility commissions already have the necessary tools and the most effective tools to deal with the issues around bypass. They already have the right to design rates, terms, conditions and rates of returns in such a manner as to benefit all consumers equitably, and that is their charge.

Some State commissions are not doing that today.

Senator **Fowler**. Let me interrupt you there again. Out of myth aiming to specificity, how should state commissions and/or the LDC suppliers of the industrials address additional costs on their remaining customers if the LDC is bypassed?

Mr. **Dudak**. I think the issues around that particular case have to be looked at very carefully. I will use my example. In our instance we offered to negotiate with the utility. They refused to negotiate.

We have other alternatives rather than just the hookup with Panhandle Eastern. We have a pipeline underneath a river to a Canadian utility that is an option. We have the conversion of the plant to liquid ethane. We have oil firing capabilities. We were going to get off the dependence of MichCon one way or another.

That specific fact tells the State commission is our state that it is up to the utility to try to market to their best to retain load that was otherwise one way or another going to leave. That is a case in which I cannot see a state commission making ratepayers pay for the imprudence of management refusing to negotiate, refusing to even try.

I do not disagree that there are cases where the public utility commissions in each State should govern bypass. They should govern bypass on purely interstate or intrastate, excuse me, intra-State bypasses. The Federal energy commission is the proper forum for interstate, and that which deals with producers and transportation deals, interstate pipelines and end users. That is a multistate issue and cannot be served by State commissions whose interests are its own state's.

Senator FOWLER. What if the gas prices rose again as they did in the seventies and you had industrial deliveries seriously curtailed? What would you argue that the obligation to serve customers of the pipelines and the LDC's would be?

Mr. DUDAK. I would not just argue. I have offered to give my abandonment approval to MichCon in several instances, and each one of my LDC's in each one of the States that we do business, and so have many of the other industrials here.

At the same time I would like to also emphasize the fact that since we have been in the natural gas marketplace, learned the business ourselves, we have learned to work hard at buying gas, much harder than the LDC's who used to serve us, and that is one of the reasons why we have lowered the costs to our burner tip.

I would emphasize that I will never go back to that LDC to buy my gas. I may go back to him to transport for me, but the current rate of return methodology of reward for risk is not the type of system that encourages hard work by LDC's and I would offer that many of the industrials that I am supported by today would have that same position. They would gladly give up abandonment by that LDC and take their chances in the future.

Mr. FOWLER. I will do my best to let you finish.

Mr. DUDAK. That is fine. We are here to hear out your questions, Senator.

One of the third myths I would like to talk about are that——

Senator FOWLER. See if you can finish up in the next couple minutes and then we will throw it open to everybody for questions.

Mr. DUDAK. There is also the myth that the barn doors are going to open and that there are going to be numerous bypasses. Well, National Steel's bypass, so-called bypass of MichCon was the first of its kind by an industrial end user in a fully argued case, a case where the LDC and the state commission both intervened and were heard at the FERC. An extensive record was developed in that case.

Some of the other pending cases that are argued to be behind that barn door swinging open are actually, in fact, LDC-type bypasses where there is a bypass by an LDC of one of its own supplier interstate pipelines. One such is being done right now by MichCon, and it is called the St. Claire River crossing in which MichCon is actually bypassing Panhandle and laying a pipe into Canada in order to provide competition to the Panhandle Eastern pipeline.

MichCon's own filing said that it was in the purpose of providing access to the Canadian markets and supplies and giving the Canadian market access to the Michigan and the domestic marketplace.

The fourth myth, bypass causes customers to leave the LDC systems. That is definitely a myth. I have offered MichCon upon several occasions to offer to compete for any one of the services that I have many times stated to them I would desire.

I would also use the example of Bethlehem in Indiana, that the threat of bypass there did not cause an LDC to lose a customer.

The fifth myth I would like to address today can best—is stated as the PUC's in the States are the best determiners of all bypass issues. I would just like to repeat that I believe the charge of most State commissions is to protect the consumers in that State, and I find it very hard to believe that a State commission can adequately address the issues in an interstate transaction where producers, interstate pipelines and end users, all of different States' background can be addresses in a particular State's hearing.

I think that is the job of the Federal Energy Regulatory Commission, and it is a very similar task, as I see it, to the task of Congress, and that is looking at what is best for the entire nation. I cannot see a shift in authority to State commissions handling interstate matters as being in the best public interest.

[The prepared statement of Mr. Dudak follows:]

BEFORE THE

SUBCOMMITTEE ON REGULATION AND CONSERVATION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

STATEMENT OF

JOSEPH R. DUDAK

ENERGY MANAGER

NATIONAL STEEL CORPORATION

September 29, 1988

Statement of Joseph R. Dudak, National Steel Corporation

I am Joseph R. Dudak, Director, Energy, National Steel Corporation. My testimony today has the broad support of the Aluminum Association, the American Iron and Steel Institute, the American Paper Institute, the Chemical Manufacturers Association, the Petrochemical Energy Group, and the Process Gas Consumers Group. A description of each of these groups is attached as Appendix A. Several of these and other industrial organizations will also be filing additional statements for the record.

U.S. industry today is increasingly competing in a world market where competitors enjoy foreign subsidies, low labor costs and overall lower production costs. Our survival directly depends on our ability to increase efficiency and to control costs. U.S. companies must review their energy outlays, a major component of most production costs, and take aggressive steps to ensure their energy suppliers charge competitive prices.

The U.S. steel industry, for example, has suffered $12 billion in losses from 1982-1986. My company, National Steel, alone lost $750 million in that time period. In 1980, the entire steel industry employed nearly 400,000 Americans. Today that figure is about 170,000. Steel, petrochemicals and other U.S. industry compete in a world market where our competitors are subsidized by foreign governments. We face intense competition from Korea, Japan and European countries.

I. The Industrial Need for Multiple, Flexible Fuel Sources

Faced with such global competition, U.S. industry has undertaken a major reassessment of its manufacturing operations in order to determine where it can reduce costs. For example, the energy cost/component of a ton of steel is roughly 25%. Since natural gas is a clearly defined cost component of our product, it is inevitable that companies have explored means to reduce the cost to them of natural gas through usage reduction and lower cost commodities. This process necessarily includes searching for alternate fuel sources and transportation service alternatives to those traditionally provided by local distribution companies ("LDCs").

It is inconceivable that legislative actions, through so-called "anti-bypass" legislation such as S. 2313 and S. 1998 are now being contemplated to take away an essential tool needed by U.S. industry to cut energy costs, thereby jeopardizing gains U.S. industry is finally making in the world marketplace. This is because such proposed legislation would impose new barriers to consumers' ability to obtain alternate gas supplies, and would make U.S. manufacturers more vulnerable than ever to monopolistic prices and practices from LDCs.

When an energy-intensive company considers alternatives to relying totally on an LDC in its vicinity, these include not only direct service of natural gas from an interstate pipeline, but also fuel substitution, shifting production to plants in other states, and conservation measures, all of which constitute a "bypass" of some or all of an LDC's gas supply. Companies facing such decisions would particularly prefer to avoid the myriad engineering, contractual, regulatory, and legal problems often associated with the direct hook-up with a pipeline. However, faced with the pressure to cut energy costs,companies are forced to consider all of these options if the LDC's gas sales or transportation component make the burnertip price excessive and not cost based. It is important to point out that unsuccessful pursuit by an energy-intensive manufacturer of options such as fuel switching or failure to achieve lower rates from the LDC will result in the ultimate "bypass" -- curtailing production or shutting down the plant altogether. If fuel switching would not be possible, production curtailment or plant shutdown would become the final option and no gas would be purchased by the industrial facility.

If S. 2313 or S. 1998 were enacted, at a minimum fuel switching would occur whenever feasible, and the LDC would lose some or perhaps all of the industrial's business anyway.

The natural gas industry and the state economy should not be allowed to be the victims of shortsighted LDCs. Consumers, industrial workers, the economy and the gas industry will all be better served by allowing competition to evolve than by artificially restrictive legislation.

The need for such an evolution is demonstrated by recent trends in natural gas prices and utility revenues. The price of natural gas purchased from LDCs reflects producer and pipeline charges (which have gone down) and a mark-up by the LDC. According to Energy Information Administration (EIA) figures, since February 1985, national average wellhead prices for natural gas have fallen nearly 40%. Interstate pipeline prices have also dropped by about 34% since January 1985, and pipeline income by about 50% since 1984.

Industrial users have not realized equivalent decreased prices from LDCs for two major reasons: (1) LDCs are regulated monopolies protected from risks facing competitive industries; and (2) the rates LDCs charge industrial users bear little relationship to the actual costs of the services provided.

First, LDCs have franchises granted by public utility commissions who have established regulatory barriers to entry. Such protection insulates LDCs from pressures faced by competitive industries struggling to make a profit in a world market. Opportunities to earn an authorized rate of return are "guaranteed" to the LDC. Because of the interrelationship of the rate base and rate of return regulation, there are few marketplace forces at work to keep the LDC's costs down or its operations efficient. For example, according to a study prepared by economist Paul London, operations and maintenance costs for regulated gas transmission and distribution companies between 1976 and 1986 rose $12 billion above the level of increase in similar expenses for non-monopoly businesses. From 1979 to 1984, productivity in the gas utility industry (measured in output per hour) declined annually by 5.1 percent according to the Bureau of Labor Statistics. Yet, based on EIA figures, average LDC margins actually rose in 1985 and 1986.

Second, LDCs are rate-regulated monopoly providers of natural gas to residential, commercial and industrial customers. The rate structures for these customer classes, approved by the state regulatory commissions, are oftentimes based on local political, rather than economic, considerations. For that reason, large industrial customers who traditionally have had no other source of natural gas other than the LDC have often paid rates far in excess of the actual cost of service.

LDCs enjoy large profits which enhance their value to their parent public utility holding company. A SEC Report in 1985 surveyed 142 public holding companies and noted that more than half (89) of those surveyed have non-utility subsidiaries. In some cases, real questions are raised as to whether monopoly profits extracted by the regulated utility have paid for the purchase and maintenance of unregulated businesses.

When an industrial gas user considers the excessive prices often charged to it by its LDC, compared to wellhead rates and the actual charges imposed by interstate pipelines, it is little wonder the industrial at least considers potential alternatives to LDC delivery of natural gas.

II. Myth & Reality of "Bypass"

The arguments raised by proponents of anti-bypass legislation are predicated on exaggerated consequences and ignore the realities of today's energy markets. The myths regarding natural gas bypass are embraced as reality by proponents of these bills. Proponents assert: (1) bypass will increase captive consumers' rates ; (2) state PUCs need this legislation passed in order to preserve and protect state authority over the delivery of natural gas in their jurisdictions; (3) bypass situations are numerous and must be contained by federal legislation; (4) bypass causes a customer to abandon the LDC system; and (5) state PUCs can better determine all rate and service issues for all customers.

Myth No. 1: Rates will increase.

Reality: Increased rates for residential and commercial customers due to "bypass" have been predicted. But this is grossly exaggerated and inaccurate for the following reasons.

First, history shows that the cost shifting argument used against other natural gas deregulatory actions was fallacious. In past natural gas debates, market forces were also predicted by many to raise rates to residential customers. This argument, for example, was made during the debate on contract carriage.

In April 1984, an LDC and pipeline sponsored study by Cambridge Energy Research Associates purported to project the consequences from the contract carriage of natural gas for the natural gas industry and consumers. On page iv of the study, the authors concluded that contract carriage "would cause higher, not lower, cost gas to most residential customers...." However, in fact, the costs of gas delivered by pipelines -- both sales and transportation volumes -- have decreased substantially since partial deregulation in 1985. The competitive thrust of contract carriage has confirmed the basic economic theory that competition and increased choices hold down prices.

These tired old arguments from the decontrol and contract carriage battles are being replayed in this "bypass" debate. LDCs assume that the total costs they are allowed to recover will remain constant and, thus, only cost shifting will occur.

History has proved those arguments wrong and, if competition is allowed to occur, history will do so again. Pipelines and LDCs can reduce costs and improve services when faced with competition. All other parts of the natural gas cycle have already. Producers, pipelines and end users all faced with competition have lowered their costs and become more efficient.

Second, even if, theoretically, all negotiations between an LDC and an industrial user fail and a large user were forced to leave the system, cost shifting to remaining customers is not inevitable. There is a third party to the transaction -- the shareholder of the LDC. When the regulated corporation is reaping huge returns at the expense of its customers, the PUC may and should require the LDC's shareholders, not its customers, to absorb any revenue losses attributable to competition, should they occur.

Myth No. 2: State PUCs need legislation to preserve authority of state commissions.

Reality: State regulators have adequate authority to protect all ratepayers, and federal legislation with that goal is unnecessary. State PUCs have the means to encourage LDCs to become more competitive and responsive to all customers through their review of LDCs' rates, return on investment, elements included in their rate bases, and their management practices. The PUC could require the LDC's return on investment to be brought closer to its authorized return, or in line with the industrial and commercial customers' return, by more closely scrutinizing the components in the rate base or taking other actions as necessary. Through such actions, the LDC need not raise residential customers' rates nor lose industrial customers. State PUCs should be urged to constructively use their established powers to protect all consumers (including industrials), before they are granted new ones.

Myth No. 3: Bypass situations are numerous and must be contained.

Reality: In fact, the FERC has approved few contested bypass cases involving direct pipeline service to an LDC user, such as in the National Steel situation in Michigan which is described in Section III of this statement. The other FERC-approved situations involve competition either between LDCs or between a municipal distributor and an LDC. While there are several direct interstate pipeline service proposals pending at FERC (with decisions presumably to be rendered over the next several years), clearly the vast majority of such proposals have either fallen by the wayside or have been settled satisfactorily between the end user and the LDC, with the industrial user and other customers receiving improved services and rates. Therefore, there are very few contested bypass situations which are actually occurring today. The threat itself is often all that induces an LDC to negotiate. That potential threat to monopoly abuse should not be removed by legislation.

Myth No. 4: Bypass causes the customer to abandon the LDC system.

Reality: Even the few companies that pursue bypass will likely continue buying some services such as primary transport for a portion of previous load, storage, and backup from the LDC. These services will be negotiated and paid for by the end user opting to do so. No free rides are expected. Therefore, these companies will not completely abandon the LDC system. The availability of alternative natural gas transportation options has functioned as a tool to force the LDC to negotiate with industrial users and resulted in a more responsive LDC. (Where the LDC won't respond as in National Steel/Panhandle case, the options had to be used.) Most often, the industrial user stays on the system with a more competitive rate and this result has generally benefitted all the LDC's customers, not just industrials who brought competition to bear on the LDC. Local economies and all consumers benefit to the extent LDCs are given competitive, economic incentives to lower their costs and rates and to improve the quality of their services. The potential of bypass is critical to inducing such cost and service improvements.

Myth No. 5: State PUCs can best determine all rate and service issues for all customers.

Reality: Some proponents of anti-bypass legislation have asserted that these matters are more properly within the jurisdiction of state PUCs. An industrial facility's direct connection to an interstate pipeline is the final link in the chain of interstate transportation. Legally, the pipeline's facilities are interstate pipeline facilities subject to FERC regulation. The user's facilities are either private (as in National Steel's case) or interstate pipeline facilities. The facilities and services are all part of the interstate transportation chain -- typically involving a long distance purchase of gas that crosses states' borders. The transaction is properly under the jurisdiction of FERC, as specified in the Natural Gas Act and Natural Gas Policy Act, and FERC can properly rule on disputes in light of national and interstate considerations which would often get little or no attention by state utility commissions.

Moreover, since a pipeline must obtain a certificate in public proceedings, all interested persons including LDCs, state commissions, and consumers have an opportunity to present their views and evidence. Each case is decided on the specific facts before FERC under Section 7(c) of the Natural Gas Act. An end user must prove to FERC that its particular bypass request is in the public convenience and necessity. National Steel was the first industrial I know of which obtained a 7(c) certificate to bypass an LDC in a contested case before FERC.

It is inappropriate to give state PUCs ultimate approval authority or veto power over a decision made by the federal statutorily designated agency on an interstate transaction. The interests of producers in Louisiana, Texas, and Colorado, for example, will not be seriously considered in Michigan. Nor will the interests of employes, suppliers and customers of affected manufacturers be considered if those companies are in other states. State PUCs can reasonably be expected to place perceived local interests over interests of interstate commerce -- which is precisely why issues of interstate commerce were reserved to the federal government under the Constitution.

Because of the above myths, anti-bypass proponents assert that extensive "bypass" will occur unless legislation is enacted. The pending anti-bypass bills severely limit FERC jurisdiction over interstate matters. It should be noted that these bills are basically being promoted by a few distribution companies, principally Michigan Consolidated and Southern California Gas Company to protect very parochial interests. First, MichCon wants to be able to retroactively upset a comprehensive FERC proceeding in the National Steel case where a 21-month process carefully considered the public interest and ruled against the utility. Second, SoCal wants to be able to prevent more natural gas being brought into the energy-short California market and thus protect its monopoly.

It should be noted also that both bills do apply retroactively. S. 2313, the Cranston bill, applies to all pending and future public convenience certificates involving bypass at FERC and to those authorized by FERC, but which have not yet begun operation.

The Breaux bill, S. 1998, directly benefits MichCon and all other LDCs that presently face competition in the form of interstate pipelines directly serving industrial customers and has far-reaching retroactive application. Under the Breaux bill, existing operations where gas is flowing may be stopped. This retroactive provision would allow interference with existing contracts between an industrial user and his supplier. Through regulatory rights given to LDCs in this bill, a utility need only petition FERC to prohibit direct service by an interstate pipeline to an industrial and FERC "shall" grant the petition if the utility is willing to transport the gas at the service cost set by the state commission.

III. The National Steel MichCon Case -- Not the Norm

As stated above, the competitive threat of alternative fuel sources has proven to be virtually the only effective club in the closet which brings LDCs to the negotiating table to discuss fair rates and service options. Speaking on behalf of my company, National Steel, I can confirm this, based on the experiences of our company's divisions in Illinois, Indiana, Minnesota and Michigan.

At the Illinois facility we purchase gas from MRT, an interstate pipeline. We considered a bypass with Trunkline pipeline and use of fuel oil. These competitive alternatives resulted in MRT responding with creative and competitive rates. No bypass needed to be pursued.

In Indiana we are served by NIPSCO which has been fully cooperative with our facility after Bethlehem Steel's bypass threat. Again, no bypass needed to be considered. And at our Minnesota plant, the LDC, Peoples Natural Gas, has worked with us at all times to provide a wide range of services, including balancing of loads and system supply as back-up.

These experiences are in stark contrast with the ones we have had in Michigan. MichCon, the LDC serving National Steel's Great Lakes Division, has consistently fought to preserve its monopoly position and monopolistic rates. MichCon has repeatedly demonstrated an unwillingness to negotiate unless National held a club over its head. The only time MichCon has negotiated has been when it was forced to do so. At one point, MichCon even told National it would "rip out its meters and cap its pipes" if we burned fuel oil. Only the threat of bypass produced improvements in MichCon's offerings and it still charged us more than double its actual cost of servicing us.

In the Panhandle Eastern/National Steel certificate proceedings before the Federal Energy Regulatory Commission, the record confirmed that MichCon charged large industrial customers distribution rates that were not based on the cost of providing the services. In 1986 MichCon was charging National Steel 71¢/MCF to transport gas a few miles as compared to the 42¢/MCF Panhandle Eastern Pipeline charges to transport gas over a thousand miles! In addition, MichCon's sales rates were tilted so that industrials were required to contribute 15 times as much as residential customers to MichCon's rate of return.

Such excessive rates paid by industrial customers have resulted in large profits enjoyed by MichCon. In 1986, MichCon was authorized a return on investment of 14.82%, while it actually realized a 20% return. In 1986-87, MichCon was ordered by the PSC to reduce its rates by more than $60 million because it had exceeded its authorized rate of return. The industrial's contribution to MichCon's return was five times the system average and 15 times the average contribution by residential customers. Clearly, MichCon shareholders, like those of other LDCs, are reaping huge returns at the expense of energy-intensive U.S. companies.

It is those shareholders who should bear any consequences of MichCon's lost load due to National Steel's departure from the system, not the ratepayer. In the National Steel case, FERC's initial decision stated that "the Michigan Public Service Commission might well conclude that MichCon's stockholders should bear the brunt of any cost shifting, perhaps by some reduction in the 17 to 19% return on equity that is currently being achieved." (Initial Decision at 28). However, reduced dividends need not even be the case since MichCon concedes in its SEC 10K report for 1987 that it "does not expect any material adverse impact from bypass in 1988 or future years." (p. 66)

FERC granted the public convenience certificate to Panhandle allowing it to directly serve us with transportation, but this occurred only after lengthy hearings and proceedings lasting 21 months and currently is on appeal at the Sixth Circuit Court. National's experience demonstrates that only the threat of competitive fuel alternatives will provide the long term solution which ensures LDCs' responsiveness to industrial users.

IV. Conclusion

Actual contested bypass situations are the aberration rather than the norm. The threat of bypass benefits all consumers -- residential, commercial and industrial -- by forcing LDCs to improve their service and rate offerings by cutting costs and improving efficiency. Residential customers have generally experienced cost decreases since deregulatory actions in the late 1970's. The old subsidy and cost-shifting arguments that accompanied the deregulatory actions at the wellhead and at the pipeline have been wrong and they do not apply to this distribution segment of the industry any more than to other segments of the gas industry.

U.S. industries are competing in a world market. Every aspect of their operations, including energy expenses, must be evaluated and the most competitive supplies sought. Passage of S. 2313 and S. 1998 would eliminate this vital tool for cutting costs from U.S. industry and would jeopardize industry's competitive position in world markets.

Appendix A

Aluminum Association, Inc.

The Aluminum Association's 91 members account for virtually all of the domestic primary aluminum ingot production and 85% of the shipments of U.S. mill products. Natural gas is an important part of the energy use pattern of the aluminum industry.

American Iron and Steel Institute (AISI)

AISI is the principal trade association of the domestic steel industry. Its 41 domestic members account for approximately 81% of the raw steel production in the United States. Members of AISI consume large quantities of natural gas in both process and non-process applications.

American Paper Institute (API)

API is the national trade association of the pulp, paper and paperboard manufacturers in the United States. API's member companies (numbering approximately 165) are major industrial consumers of natural gas, using approximately 340 Bcf of natural gas a year.

Chemical Manufacturers Association (CMA)

CMA is a non-profit trade association of 170 member companies. CMA's member companies represent more than 90% of the productive capacity of basic industrial chemicals in the United States. They use 25% of the industrial gas consumed in the United States and 10% of the total U.S. gas consumed.

Petrochemical Energy Group (PEG)

PEG is an ad hoc group of independent petrochemical companies that use natural gas not only as boiler and process fuel but also as raw materials, or feedstocks, for the production of petrochemical products. The petrochemical industry has plants in all regions of the country. PEG companies purchase gas from local distributors, interstate pipelines, intrastate pipelines, and directly from producers.

Process Gas Consumers Group (PGC)

PGC is an association of 18 industrial consumers of natural gas, organized to promote the development and adoption of coordinated, rational, and consistent federal and state policies with respect to gas service to industrial process gas users. PGC members own ad operate hundreds of plants in virtually every state in the nation.

Senator **Fowler**. Mr. Dudak, thank you very much.

I see the Congress has gone into session, and I do not want us to interrupt the completion of this hearing by the votes.

Mr. Saltzman has a question or two.

Did you not? [Laughter.]

Mr. **Saltzman**. Dr. Cooper, you said earlier that FERC freed the pipelines of obligations but not the LDC's. What about the FERC order 380 series which freed the LDC's of paying minimal bills.

Dr. **Cooper**. They have been freed in part, but as you heard testified by this morning, there are other obligations. Demand charges that the pipeline can doubly collect. So, what you have here is a partial market, a partial freedom, and you have pipelines having an advantage. They can go across, and you have heard the term cherry-pick or cream skim, find the most lucrative customers, and while the LDC's still have their hands partially tied.

Mr. Fowler asked the question are you for open access. Yes, we are for open access, and we want it to be really open. We want an equal chance for all players to play.

This morning I found it remarkable to hear that the these transportation systems are in the spirit of competition. Let us remember where these transportations came from. They came from a people's council suing on discrimination, not the spirit of competition. That is, some consumers were being discriminated against and we believe, still are being discriminated against.

So, yes, you are absolutely right. The system is more open, but it is not a level playing field, and at the moment the LDC's are not equal actors, and the captives who suffer that cost are the residential ratepayers who can't plan to bypass.

The federal bypass is great if you can credibly make it, but we cannot.

Mr. **Saltzman**. If gas supplies tightened and prices go up as they did in the seventies, will the pipelines have an obligation to serve those captive customers in the same way that consumer groups were advocating in the seventies?

Dr. **Cooper**. Let us be clear. That is a good point. You have heard the offer of abandonment that National Steel says we will agree to abandon our service. The local distribution company cannot, and that is a fundamental difference between an end user who says, look, I will leave town if I can. Cascade cannot leave town. It has customers it is obligated to serve.

A local distribution company cannot leave town. And we are paying the price for that obligation to serve. And it is a fundamental inequity and difference in market power, if you will, when you have some ratepayers or some customers who can say look, I will leave town.

So, we would insist on the obligation to serve, and we pay the price of that obligation to serve under the current system. You cannot have some actors who do not pay the price but could come back and some actors who do.

So, we will insist on the obligation to serve, absolutely.

Mr. **Saltzman**. Are the State commissions going to get consumers, industrial States' gas if this is left to the State commissions when gas supplies tighten? Why would this be a responsibility of federal regulators?

Dr. COOPER. The State level is the responsibility of local distribution companies under the regulation of the State public utility commissions. The obligation to serve is serious, and the public utility commissions will continue to insist on it. But the actual act of acquiring the gas is an act of the local distribution company.

They will be expected and, I mean, we have had examples to have the gas to serve the customers, and they will go to their interruptible customers who pay lower rates for their quality of service and say we have an obligation to serve these people. You had signed a contract. You have been enjoying a rate that is less than our firm transportation or our firm service rate, and we will interrupt you now. It has happened, and it may happen in the future. That is the nature of the market.

But there is a set of core customers who they are obligated to serve, and they ought to meet those obligations.

Senator FOWLER. Mr. Porter, does competition in the interstate gas market in Louisiana help the producers with an intrastate pipelines to market their gas?

Mr. PORTER. Competition definitely is healthy and I think without it the producers would not benefit to the degree that they do.

Senator FOWLER. Well, now, you are sitting between these two tigers on either end here. You have heard their arguments. What do you say to the notion advanced sort of between the lines that competition for markets in LDC service areas would also help Louisiana producers intrastate?

Mr. PORTER. In my opening statement I realized I was between these two tigers, and that is why I tried to talk about us being a producer and a consumer, and we will not—our gas will be exported.

What I see is that there is no doubt but what the open access transportation is very good. It is beneficial to our overall system.

All I am saying is let us do not get in a situation where in doing that we take and we will do whatever is necessary to get this gas to a particular large user maybe at a very competitive price, and then do damage to that distribution system which is on the other end of delivery, and that is the LDC because I really think that in that particular case, we are dealing more than with competition. We are dealing with regulation, regulation that is done by different levels of government for different purposes.

And that is the only thing that I was wanting to say is that let us not do harm and get this system messed up again.

Senator FOWLER. Mr. Noland, on behalf of the Louisiana Producers, do you believe that producers should be able to sell to pipelines or LDC's or the industrials direct?

Mr. NOLAND. I believe the producer ought to be able to sell to whomever he wishes. And it is always a price negotiation.

The problem is the producer usually has to go beg somebody to buy from him. It is not like people come beat your door down to buy gas today. And I think producers—we have not dug a gas well in six years and do not have any on our drawing boards to dig. We cannot afford to dig any gas wells. The economic payback is not there. And the customer is not there. Nobody calls on us and wants us to dig a gas well.

You know, if these big companies were really serious about wanting cheap gas, they ought to go dig their own gas wells out there. You do not see any of them wanting to do that. They want to ride on the producers' back and make him take the risk and then they want the cheap gas.

That is asking an awful lot. That is asking a farmer to farm for nothing so you can get eggs for 30 cents a dozen in the grocery store. It is not going to work.

But in answer to your questions, Senator, yes, sir, I believe that the producer ought to have the right to sell to whomever he wishes.

Senator Fowler. Not so much in my own following of this, but to play off certain things that were just said by Dr. Cooper and others, let me put it the other way just to make the record on your behalf as clear as possible.

If you are willing to compete to market your gas as you said, to LDC's and industrials, what about—if that were the case, would you be willing to forego, say, your take or pay claims against the pipelines?

Mr. Noland. The take or pay contracts we had turned out to be not even worth the paper they were written on. They were not lived up to. The contracts were broken. So, I would be glad to give up those.

Senator Fowler. I see why Louisianians have a reputation for straightforwardness.

Mr. Saltzman. Mr. Noland, just for the record, are you representing Louisiana producers?

Mr. Noland. No, sir, I am representing myself.

Mr. Saltzman. You say you currently do not have any production?

Mr. Noland. No, I said I am currently not drilling any gas wells and have not drilled a gas well in six years.

Mr. Saltzman. But you do have small production. Who are your customers?

Mr. Noland. Little gathering companies, LIG, for example, Louisiana Interstate Gas buys from us.

Mr. Saltzman. And who buys from the gathering companies?

Mr. Noland. LIG is a subsidiary of Tenneco, so I assume it ends up in Tenneco.

Mr. Saltzman. And then goes into the interstate market?

Mr. Noland. If it goes to Tenneco, I assume you are right. I am not privy to that information, Counsel.

Mr. Saltzman. Do you believe that given that your supplies that go into the gathering system go into the interstate market are ~~available to~~ the interstate market, does it not help market your gas? Does it not aid in the marketing of your gas to let LDC's and industrials and pipelines compete for their supplies of gas?

Mr. Noland. In the short run I agree with you, but in the long run if the major pipelines get a hold of all of the volume customers, the volume customers are going to beat on them for a little price, and they are going to turn around and beat the producer into a lower price, and the producer is going to do just what he is doing now. He is not going to dig gas wells. He is going to shut in the ones he has or as is happening over in Texas, he is going to flare the gas, which is an unbelievable thing.

If you think in terms of the last ten years and then you are going to run out of people willing to take the risk to dig gas wells. And as Senator Breaux said, that is the cleanest burning fuel we have in America.

Mr. **Saltzman**. Mr. Porter, are you here appearing on behalf of the Louisiana Department of Natural Resources?

Mr. **Porter**. No. I said I was a former secretary of natural resources. I am not a state official. I am not appearing on their behalf. I am appearing here as myself.

Mr. **Saltzman**. Are you a paid consultant?

Mr. **Porter**. I am not paid by any oil industry because Louisiana right now, I am under a two-year ethics situation. I cannot appear back before any of the agencies for two years.

Mr. **Saltzman**. Are you a paid consultant of any group here?

Mr. **Noland**. No, sir.

Senator **Fowler**. You are probably the only two in the room. [Laughter.]

Mr. **Noland**. Is that good or bad?

Senator **Fowler**. That is good. That includes up here. Gentlemen, thank you very very much for your testimony and helping us complete thoroughly the record.

In conclusion, again my thanks to Ms. Catherine Cook, the General Counsel of the Federal Energy Regulatory Commission. Ms. Cook is a veteran testifier before the Congress.

We will certainly make your thorough statement a part of the record, and you may proceed as well. And I do appreciate this little flip-flop in the way that we do business this morning.

But I think it will be helpful in the long run as part of this public education process for the responsible agency to hear as many sides as possible. So you may proceed as you will.

STATEMENT OF CATHERINE C. COOK, GENERAL COUNSEL, FEDERAL ENERGY REGULATORY COMMISSION

Ms. **Cook**. Thank you, Mr. Chairman. I will give an abbreviated version of my statement. I appreciate the opportunity to comment on issues raised by the Subcommittee's consideration of S. 1998 and S. 2313.

Bypass was used today to describe a situation wherein an interstate pipeline transports natural gas to an industrial or large commercial end user presently or previously served by the LDC.

That term also applies to a situation wherein a pipeline transports natural gas to an LDC customer of another pipeline. But that has not been much at issue today.

Bypass arises then end users and other shippers in their quest for reliable natural gas supply at the lowest cost contract directly with pipelines, thereby bypassing local distribution companies.

Only three times in the last three years has the Commission certificated an LDC bypass. Today, only two possible LDC bypasses are the subject of applications.

I believe that the public interest is best served by the Federal Energy Regulatory Commission's overseeing the interstate natural gas market, and by LDC's having both the benefits and the risks of competition.

The proposed legislation is intended to ensure fair competition. However, I do not think it would do this. Both bills could adversely affect the interstate natural gas market, could adversely affect competition, by shielding local distribution companies from the burdens of competition while at the same time giving them a competitive edge and giving State commissions the power of the ultimate decision.

S. 1998 provides that the local distribution company gets—that the Commission must prohibit bypass if the local distribution company is willing to transport at the cost of providing the service as determined by the State commission. Nor is this bill limited to new transactions.

Any existing certificate, and I think Senator Nickles earlier asked if the proposed legislation might result in the Northwest matter in having a retroactive effect. One reading of that legislation to me would say, it may well.

Any existing certificate, no matter now long it has been in effect, is subject to challenge by a distribution company. And if the distribution company is willing to transport without discrimination, then the Commission must revoke the certificate.

The possibility of revocation could affect the ability of all pipelines to obtain or even retain financing. To my knowledge, the Commission has never revoked a certificate over the objection of the certificate holder. I find this troublesome.

The other bill provides that the Federal Energy Regulatory Commission shall not allow bypass if the State or local commission certifies that the bypass would prejudice the present or future interests of the customers of the distribution company. It shall not allow bypass if it could hurt in the present or in the future.

Under both bills, if a distributor objects to a proposed bypass and is willing to provide the service itself, the Commission must deny authorization. However, there is no requirement that the service offered by the willing distribution company be equivalent to the service offered by the pipeline.

Accordingly, a distribution company could prevent a consumer from getting firm service from a pipeline by offering to provide interruptible service on the grounds that the pipeline's firm service would displace the distributor's interruptible.

The Committee has asked also if I—not only asked whether I would support enactment of the bill, as you had specific questions with respect to the bill's effect on take or pay, on open access, and on cost-shifting.

First, take or pay. The proposed legislation would not materially affect the Commission's take or pay policies. Under Order 500, that would go on that the requirements and the policies under Order 500 for cross-crediting, the ability to pass through, buy-out and buydown costs, the possibility of a gas inventory charge, would be unchanged, although it is true that the responsibility among customers might be distributed differently.

On the other hand, the proposed legislation could undermine the Commission's open access transportation program. That program was designed to allow shippers, including distributors, to benefit from the competitive wellhead market created by Congress in the Natural Gas Policy Act.

However, if local distribution companies are shielded from competition while at the same time they are allowed to enjoy the benefits of competition, market distortions and inefficiencies will result, and the open access transportation program will be adversely affected.

In today's regulated world, LDCs can take advantage of the opportunities created by increased competition. They can rely on a variety of suppliers and offer a variety of services.

Finally, the Committee asked how the Commission ensures that cost-shifting will not occur if a local distribution company is bypassed. We cannot ensure this. The Commission does not have jurisdiction over LDC rates.

If an LDC is bypassed, the State commission has the authority to determine whether any higher unit costs of service should be absorbed by the LDC's remaining customers, or by the shareholders of the LDC.

The State commission is an a position to provide for a fair allocation of costs arising from the bypass. State commissions can also play a role in controlling the risk of bypass by requiring rates that are market-responsive and that avoid cross subsidies.

The real protection from cost-shifting, from bypass, is active participation by LDCs in the competitive market. The threat of bypass produces the protection.

So long as LDCs provide sales gas for transportation at competitive prices, end users have no incentive to seek bypass. Indeed it appears increasingly that LDCs are willing to meet the competitive challenge.

I believe that the Commission has demonstrated good faith and a willingness to protect the public interest in the area of LDC bypass. And I believe that the public interest is best served in this instance by the Federal Energy Regulatory Commission's continuing to oversee the interstate natural gas market.

Thank you for the opportunity to appear before you.

[The prepared statement of Ms. Cook follows:]

STATEMENT OF

CATHERINE C. COOK

GENERAL COUNSEL

FEDERAL ENERGY REGULATORY COMMISSION

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

SEPTEMBER 29, 1988

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I appreciate the opportunity to comment on issues raised by the Subcommittee's consideration of S.1998 and S.2313.

These bills concern bypass. Bypass is a term which describes a situation where an interstate pipeline transports natural gas to an industrial or large commercial end-user presently or previously served by a local distribution company (LDC). The term also applies to a situation where a pipeline transports natural gas to an LDC customer of another pipeline. Most of the controversy, as well as the subject matter of the two bills under consideration, involves the former situation.

Bypass arises as a consequence of increased reliance on competition in natural gas markets. End-users and other shippers, in their quest for reliable natural gas supplies at the lowest cost, are increasingly exploring the possibility of direct transactions with pipelines, thereby "bypassing" local distribution companies.

In addressing bypass issues the Commission balances competing interests and goals under the authority delegated to it by Congress. Consistent with its regulatory responsibilities, the Commission tries to allow persons to make choices and to give those choices effect.

The proposed legislation is intended to ensure fair competition, to encourage open access transportation by local distribution companies, and to coordinate the regulatory authority of the FERC and the State commissions. However, I do not believe that the bills would achieve these objectives. Rather, both bills would shield local distribution companies from competition and could adversely affect the natural gas market.

A summary of the bills (Attachment A) will clarify the basis of my concerns. I am also attaching a description of certain technical matters for the Subcommittee's consideration. (Attachment B)

S.1998 provides that any State, municipality, State commission, or local distribution company may petition the Federal Energy Regulatory Commission to prohibit an interstate pipeline from transporting gas in interstate commerce for any person, if the transportation will displace or bypass any sales or transportation provided or offered by a local distribution company. The Commission may grant the petition even if a certificate authorizing the transportation was previously issued. The Commission must grant the petition if it is shown that (1) the local distribution company is willing to transport or is transporting gas without discrimination on the basis of source, ownership, or destination, and (2) the local distribution company is willing to transport or is transporting at the cost of providing the service as determined by the State commission.

In other words, the Commission would have to deny a pipeline's certificate application if a distributor offered to provide the service, regardless of the economics for the consumer. Nor is S.1998 limited to new transactions. Any existing certificate, no matter how long it has been in effect, is subject to challenge by a distribution company. And if the distribution company is willing to transport without discrimination, then the Commission must revoke the certificate. The possibility of revocation could affect the ability of all pipelines to obtain or even to retain financing. To my knowledge, the Commission has never revoked a certificate over the objection of the certificate holder. I find this troublesome.

The other bill, S.2313, provides that the Federal Energy Regulatory Commission shall not permit service that would displace any service being provided or which could be provided by a local distribution company, if the State or local commission certifies that the service would prejudice the present or future interests of the customers of the distribution company. This bill appears to allow a State commission to veto service by a pipeline, whether or not the LDC is willing to provide service. In addition, S.2313 would not allow the Commission to permit service if a local distribution company protests and the proponent of the service fails to demonstrate, after a hearing on the record, that the distribution company is not willing to provide transportation service on terms and conditions approved by the State commission.

Under S.2313, as well as under S.1998, if a distributor objects to a proposed bypass, and is willing to provide the service itself, the Commission must deny authorization. However, there is no requirement that the service offered by the willing distribution company be equivalent to the service offered by the pipeline. Accordingly, a distribution company could prevent a consumer from getting firm service from a pipeline by offering to provide interruptible service, on the grounds that the pipeline's firm service would displace the distributor's interruptible service.

In addition to asking whether I support enactment of the bills, you had specific questions with respect to the bills effect on take-or-pay, open-access, and cost shifting.

First, take-or-pay. The proposed legislation would not materially affect the Commission's take-or-pay policies. Those policies, embodied in Order No. 500, include a crediting mechanism to offset the accumulation of take-or-pay when a pipeline transports gas for others under the open access rules, a means for pipelines to recover from their sales customers through fixed and volumetric charges the costs of settling take-or-pay obligations, and a way for pipelines to charge their sales customers for maintaining natural gas inventories. Nothing in the bills under consideration would alter these policies, although their application may be affected to the extent the proposed legislation changes the customer profile of a pipeline. The responsibility among customers for take-or-pay may be distributed differently.

On the other hand, the proposed legislation could undermine the Commission's open access transportation program. That program was designed to allow shippers, including distributors, to benefit from the competitive wellhead market created by Congress in the Natural Gas Policy Act. However, if local distribution companies are shielded from competition, while at the same time they are allowed to enjoy the benefits of competition, market distortions and inefficiencies will result, and the open access transportation program will be adversely affected. That program, by the way, has been in large part successful. Pipelines serving a vast portion of United States markets are now open. To the extent that the proposed legislation would impede willing buyers from having access to willing sellers, Congress' goal of reliable gas supplies at the lowest reasonable cost through competition would be thwarted.

The conflicting interests of all participants in the natural gas market--producers, pipelines, distributors, and consumers--are best resolved through fair and open competition, without giving a competitive edge to any one group. In this regard, the Commission has taken several actions, in addition to encouraging pipelines to transport for others, to expand LDCs' opportunities to choose from a variety of sources for competitively priced gas. On a generic basis, the Commission has eliminated variable cost minimum bills from pipeline tariffs. Order No. 380, 49 Fed. Reg. 22778 (June 1, 1984); 18 C.F.R. § 154.111 (1988). On a case-by-case basis, the Commission has removed "sole supplier" clauses and fixed-cost minimum bill provisions from pipeline tariffs, so that LDCs are not discouraged from purchasing supplies from other than their traditional pipeline supplier. See, e.g., Panhandle Eastern Pipe Line Company, Opinion No. 265, 38 FERC ¶ 61,164 (1987) (sole-supplier clauses) and Transwestern Pipeline Company, Opinion No. 238, 32 FERC ¶ 61,009 (1985)(fixed-cost minimum bills). And, of course, within the open access program, the Commission has required pipelines to allow their distribution customers to convert their firm sales contracts to transportation and has allowed pipelines to offer standby sales service in connection with transportation.

In today's regulated world, LDCs can take advantage of the opportunities created by increased competition. They can rely on a variety of suppliers and offer a variety of services. LDCs can aggregate supplies, and can rely on a mix of long-, medium-, and short-term supply contracts with producers and marketers as well as traditional pipeline sales. Increasingly, they are gaining access to a range of pipeline services including transportation, sales, gathering and storage.

You have asked how the Commission ensures that cost-shifting would not occur if a local distribution company is bypassed. We cannot ensure this. The Commission does not have jurisdiction over LDC rates. If an LDC is bypassed, the State commission has the authority to determine whether any higher unit costs of service should be absorbed by the LDC's remaining customers or by the shareholders of the LDC. The State commission is in a position to provide for a fair allocation of costs arising from the bypass. State commissions can also play a role in controlling the risk of bypass by requiring rates that are market responsive and that avoid cross-subsidization.

I believe that active participation by LDCs in the new competitive market is the most effective protection for the LDCs against vulnerability to bypass. So long as LDCs provide sales gas or transportation at competitive prices, end-users have no incentive to seek bypass. Indeed it appears that LDCs are willing to meet the competitive challenges. LDCs and their shareholders are willing to decide how best to serve their customers' needs and to live with their decisions.

A study by the Interstate Natural Gas Association of America indicates how LDCs are responding to the new world of competition. Transportation to market for distributors increased by 618 percent from the first quarter of 1984 to the first quarter of 1988. Distributors are taking advantage of transportation opportunities to reduce gas costs. These actions can reduce their exposure to bypass. The experience at the Commission supports this proposition. Currently, there are only two applications pending involving an LDC bypass. In fact, the Commission has issued only three certificates under the Natural Gas Act in the last three years that resulted in an LDC bypass.

I believe that the Commission has demonstrated good faith and a willingness to protect the public interest in the area of LDC bypass. I believe that the public interest is best served in this instance by the Federal Energy Regulatory Commission's overseeing the interstate natural gas market, by LDCs' having both the benefits and the risks of competition, and by State commissions' allocating LDC costs.

Thank you, for the opportunity to appear before the Subcommittee today.

ATTACHMENT A

100TH CONGRESS
1ST SESSION

S. 1998

To regulate interstate natural gas pipelines providing transportation service which bypasses local distribution companies and to encourage open access transportation by local distribution companies at cost-based rates.

IN THE SENATE OF THE UNITED STATES

DECEMBER 22 (legislative day, DECEMBER 15), 1987

Mr. BREAUX introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To regulate interstate natural gas pipelines providing transportation service which bypasses local distribution companies and to encourage open access transportation by local distribution companies at cost-based rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Natural Gas Consumers Protection Act".

SEC. 2. FINDINGS AND PURPOSES.

(a) FINDINGS.—The Congress finds that—

(1) certain interstate pipelines are building facilities to interconnect with large industrial natural gas users currently served by local distribution companies thus causing needless duplication of facilities and economic inefficiency;

(2) the Federal Energy Regulatory Commission has promoted such local distribution company bypass by creating unfair marketing opportunities for interstate pipelines at the expense of local distribution companies and small consumers;

(3) unfettered bypass will allow the interstate pipelines to consolidate unfairly their monopoly positions to the detriment of producers, consumers, and distributors of natural gas;

(4) States have an essential role to play in the regulation of retail natural gas rates within their borders;

(5) the Federal Energy Regulatory Commission's bypass policy removes the ability of State commissions to structure fair and equitable rates for gas consumers within their States; and

(6) the Federal Energy Regulatory Commission has failed to devise a Federal policy that respects State concerns and acknowledges the inherent unfairness and

inefficiency of forcing local distribution companies to compete with interstate pipelines.

(b) PURPOSES.—The purposes of this Act are to—

(1) protect residential and small commercial users of natural gas from interstate pipeline market-raiding activities that may benefit a few large natural gas consumers, but which will burden the vast majority of natural gas users with higher rates;

(2) restore the ability of State commissions to structure fair and equitable rates for all gas consumers within their States;

(3) prevent interstate pipelines from consolidating unfairly their monopoly positions to the detriment of producers and consumers of natural gas;

(4) help assure fair competition between interstate pipelines and local distribution companies;

(5) provide for the long-term viability of the natural gas market; and

(6) prohibit the bypass of a local distribution company by an interstate pipeline if the local distribution company is willing to transport natural gas without discrimination at the rate for such service established by the State commission.

SEC. 3. UNECONOMIC BYPASS PROHIBITED.

Any State, municipality, State commission, or local distribution company may petition the Federal Energy Regulatory Commission to prohibit an interstate pipeline from transporting gas, either directly or indirectly, in interstate commerce for any person, which transportation is displacing or bypassing, or will displace or bypass, any or all sales or transportation services provided or offered to such person by a local distribution company. The Commission may grant the petition notwithstanding the fact that a certificate of public convenience and necessity authorizing such transportation has previously been issued by the Commission. The Commission shall grant the petition if it is demonstrated that the local distribution company is—

(1) willing to transport or is transporting ga without discriminating on the basis of the source, ownership, or destination of the gas; and

(2) willing to transport or is transporting gas a the cost of providing that service as determined by it State commission.

SEC. 4. DEFINITIONS.

As used in this Act—

(1) the term "interstate pipeline" means an person engaged in the interstate transportation of natural gas;

(2) the term "local distribution company" means any person, other than any interstate pipeline or any intrastate pipeline (as such term is defined in section 2(16) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301(16)), engaged in the transportation, or local distribution, of natural gas and the sale of natural gas for ultimate consumption; and

(3) the term "State commission" means the regulatory body of the State or municipality having jurisdiction to regulate rates and charges for the sale of natural gas to consumers within the State or municipality.

○

II

100TH CONGRESS
2D SESSION

S. 2313

To coordinate the regulatory authority of the Federal Energy Regulatory Commission with that of State or local regulatory agencies relative to service which would bypass local utility service and to facilitate the resolution at the State or local regulatory level of competition policy issues relating to local service.

IN THE SENATE OF THE UNITED STATES

APRIL 22 (legislative day, APRIL 11), 1988

Mr. CRANSTON introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To coordinate the regulatory authority of the Federal Energy Regulatory Commission with that of State or local regulatory agencies relative to service which would bypass local utility service and to facilitate the resolution at the State or local regulatory level of competition policy issues relating to local service.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

. This Act may be cited as the "Natural Gas Transition Act of 1988".

SEC. 2. BYPASS RESTRAINT.

(a) The Federal Energy Regulatory Commission shall not permit service pursuant to the Natural Gas Act or the Natural Gas Policy Act of 1978 where that service would displace any service being provided or which could be provided by a local distribution company if—

(1) the State or local commision with jurisdiction over an affected local distribution company certifies to the Commission that, in its judgment, the service would prejudice the present or future interests of the customers of the affected local distribution company; or

(2) the proposed service is protested by an affected local distribution company and the proponent of the service fails to demonstate, after a hearing on the record, that the affected local distribution company is not willing to provide transportation service on terms and conditions in effect, or accepted or approved by its State or local commission.

(b) In no event shall the Commision permit service that would displace any service being provided or which could be provided by a local distribution company unless and until thirty days after the Commission has published a notice of the proposed service in the Federal Register.

(c) For purposes of this Act, the term "local distribution company" means any entity engaged in the distribution of natural gas for consumption and regulated or operated as a pubic utility by a State or local government or agency thereof.

(d) This Act shall apply to all service not provided before the date of enactment of this Act, regardless of whether the authority to provide such service was granted by the Commission before such date.

○

ATTACHMENT B

1. The bills each contain definitions of "local distribution company" that are different from each other.

   S.1998, section 4(2): "[T]he term local distribution company means any person, other than any interstate pipeline or any intrastate pipeline (as such term is defined in section 2(16) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301(16)), engaged in the transportation, or local distribution, of natural gas and the sale of natural gas for ultimate consumption...."

   S.2313, section 2(c): "For purposes of this Act, the term local distribution company means any entity engaged in the distribution of natural gas for consumption and regulated or operated as a public utility by a State or local government or agency thereof."

   This is bound to cause confusion. A a single definition applicable in all circumstances would be desirable

2. S.2313, section 2(a)(2) gives a pipeline the burden to prove that a distribution company is not willing to provide service. Generally, it is not desirable to impose the burden on a party to prove a negative, since such a burden of proof is so overwhelming as to be unfair in most instances. In this case, only the distribution company would know under what circumstances it was willing to provide service, and it would have no incentive to share the information with the pipeline.

3. Neither bill requires the distribution company to use its own facilities to provide service or limits the distribution to company its own service area. This could have some extreme effects. For instance, a distributor could offer to install a meter to serve the customers of an open access pipeline--even though that customer had never been served by the distributor and wasn't even in the distributor's service area. Because the pipeline would be an open access transporter, the distributor could demand that the pipeline transport gas to the customer on the distributor's behalf. Under S.1998, the Commission would have to prohibit the pipeline from continuing to serve the customer, regardless of the quality or price of service offered by the distribution company through the facilities of the open-access pipeline.

Senator FOWLER. Thank you. Mr. Saltzman has some questions.

Mr. SALTZMAN. Thank you. In the Cascade decision that Mr. Gerarden discussed on the first panel, did FERC consider the effect of the bypass on Cascade when it made that decision?

Ms. COOK. The decision is on rehearing, by the way. But as the gentleman from Cascade indicated, it certainly did not consider it when it made its jurisdictional call.

It ultimately decided the matter was moot, because Northwest accepted a blanket. So the answer is, it did not have to.

Mr. SALTZMAN. As a general matter, then, is it FERC's policy now that its jurisdiction ends at the city gate, the transfer point between the interstate pipeline and the local distribution company, and it need not consider public interest factors beyond that city gate?

Ms. COOK. That is not FERC's position and it never has been. If, for example, if an end user, a large industrial, wanted to bypass, we would certificate the rates to start with.

We have to look, pass on the rates, and the transportation has to be certificated. So we would consider all relevant factors. And certainly the role, the willingness of the LDC, would be one of those factors.

Mr. SALTZMAN. Does the Commission have a set of criteria for determining that Section 7(c) public interest consideration of all the consumers?

Ms. COOK. It has no rule because it considers this something that has to be done on a case-by-case basis. They are all different.

Mr. SALTZMAN. In recent Commission declaratory order, I believe in the Hadson case, that came I believe on the same day as the Cascade case——

Ms. COOK. It did, yes.

Mr. SALTZMAN. The Commission gave a new interpretation or an additional interpretation of its obligations under Section 311 of the National Gas Policy Act, in the "on behalf of" test.

Could you discuss that a bit? And could you explain, as a second part of that question, why any entity wishing to bypass would now even have to go to the Commission and seek a 7(c)?

Ms. COOK. When the Commission articulated the "on behalf of" policy under Section 311 in the Hadson matter, it brought together some of its earlier statements. I would not describe it as a new policy.

However, there had been a lot of confusion. Not everyone believed that the "on behalf of" test meant what the Commission said it meant that day. So to that extent, it was an event.

And what that event meant would be that you would not have to come to the Commission, you could transport on behalf of an intrastate or an LDC to someone else, and it would only require nominal agency-type interest, some financial interest.

So it does mean that today, without coming to the Commission, that transportation could be done on behalf of an LDC, let us say an LDC in New York. You have transportation to end user that was somewhere in the central part of the United States.

The next part of your question is, why would anyone then bother to do it any other way? If you are going to do this kind of, if you are going to bypass, you are supposed to let us know, you are supposed to let the LDC know, and you are supposed to let the State commission know.

I tried to find out coming in here this morning how much of this has been going on. And we have not had very many notifications. I asked a few questions as to why is there not, is there a lot of this going on. Nobody seemed to think there was a lot of it going on.

Why is there not a lot of it going on? Well, maybe it is because an end user likes to keep control of his own contracts, does not want to have the transportation take place on behalf of someone else. I do not know, but it sounds like we are not ready to have a solution because I have not seen the problem.

Senator FOWLER. Ms. Cook, on behalf of the Commission and on behalf of FERC, you have heard many of the conflicting approaches to Federal jurisdiction this morning. I do not want to narrow it too much for you, especially on the issue of Federal-State jurisdiction.

Ms. COOK. It is no surprise that those with local interests prefer local regulators to make their financial decisions.

It is also no surprise that interstate pipelines and producers who are in an interstate market do not want local regulators in many, many different jurisdictions to have increased control over their financial lives.

And I suppose it is no surprise if I as a Federal regulator think that the interstate market should best be overseen by a Federal agency. People are voting or speaking where their influence is and what is in their financial interest.

So no surprises here today, I would say. Except perhaps for Dr. Cooper. And——

Senator FOWLER. He is a big fellow. He can take some criticism. Go ahead.

Ms. COOK. I know. And he can dish it out, too. I think we have taken into account the local distribution companies a lot more seriously, have looked at that as part of our regulatory responsibility. I think we have done this in greater degree than he gave us credit for.

We have done it in minimum bills, we have looked in Order 380, relieved on variable costs. We do it case by case for fixed cost. We have removed sole supplier contracts. We had in Order 436 contract demand conversions.

We tried to get contract demand reduction provisions and we lost on that in the court, and we have not yet given up on that. We may yet have something like that in a final rule.

When Order 436 was decided by the Court of Appeals for the District of Columbia in June of 1987, the court looked at the idea. You know, there has been a lot of criticism about LDC's and what we were doing, and what is the difference when you have State regulation and you have Federal regulation?

And the court pointed out that just because some States impose greater burdens on LDC's than other States do, that does not mean that the Federal agency cannot on a national market regulate competition. There is a tension here, no question about it.

But I think what we need to be concerned with is the national market, and ultimately the States will come around. They are coming.

Senator **Fowler**. Ms. Cook, for the record, the staff would like—I will give this to you afterwards. But for the record there are a couple of questions that I would like to—it is going to take a little work on your behalf, if you would give us the answers in the next two to three weeks.

Ms. **Cook**. Certainly, Senator.

Senator **Fowler**. The first one is—well, I do not have to read them. I will just hand them to you. They are detailed and will require some research. Basically on matters that you raised on how many of these proposals are pending, and it is something that will aid us.

Let me thank all the witnesses and say again what most of you who have been here all morning heard me say. There are legitimate criticisms of the Congress—this is my twelfth year in the Congress—that we never have public hearings on matters until we have already determined that we are going to pass some legislation a week later. That is certainly not the purpose of the public hearing requirement.

And though it is quite legitimate for various sections of the public or business to hope that issues involving their livelihood, or involving their country, will just sort of go away, this is an issue, as you have seen this morning, that is not going to go away, and I assume will even continue to be complicated if we had again very serious price fluctuations in the market.

But let me repeat, we are ending the 100th Congress of the United States of America. We will not be legislating in this field during the remaining days.

And this public hearing has been held simply to air many of these responsible proposals and responsible differences, not only affecting producers, distributors, but in certain ways affecting our relationships with the Canadians to the north and the Mexicans to the south, and has international as well as domestic implications in all these issues that were raised.

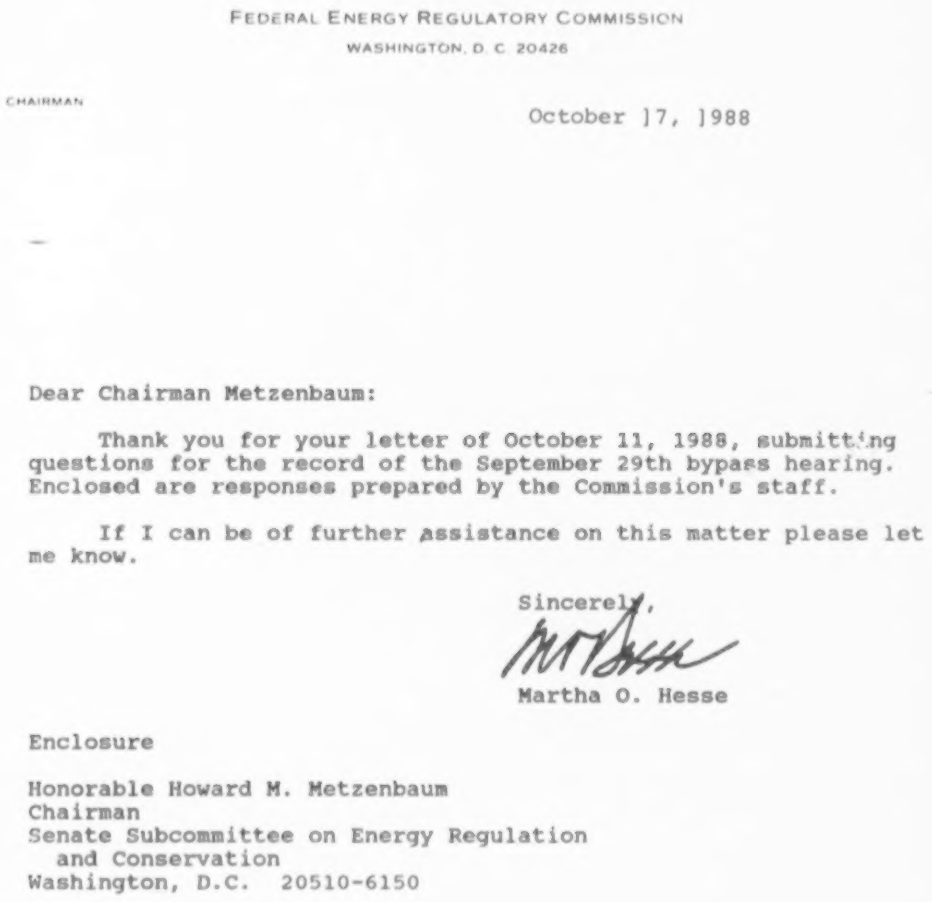
All of your testimony will be very helpful for our review. And since we are only 3 weeks before the national elections we not only do not know at this time what the future holds, we do not know who holds the future. Thank you very much.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

APPENDIXES

APPENDIX I

Responses to Additional Questions



FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D. C. 20426

CHAIRMAN

October 17, 1988

Dear Chairman Metzenbaum:

Thank you for your letter of October 11, 1988, submitting questions for the record of the September 29th bypass hearing. Enclosed are responses prepared by the Commission's staff.

If I can be of further assistance on this matter please let me know.

Sincerely,

Martha O. Hesse

Enclosure

Honorable Howard M. Metzenbaum
Chairman
Senate Subcommittee on Energy Regulation
and Conservation
Washington, D.C. 20510-6150

Additional Questions from Senator Fowler

Question 1: How many transportation bypass proposals are currently pending before the Commission where the pipeline proposes to transport

(a) under traditional NGA section 7(c) certificate authority; and

(b) under Order 436/500 blanket certificate authorization.

Of the latter category, how is the Commission able to determine whether a bypass is contemplated, given the highly abbreviated procedures required of pipelines?

Answer: (a) There are two pending proposals by interstate pipelines to bypass local distribution companies under the traditional procedures of section 7(c) of the Natural Gas Act. These are the proposals by (1) Northern Natural Gas Company in Docket No. CP88-540-000, which would bypass Iowa Public Service Company, and (2) Northwest Pipeline Corporation in Docket No. CP88-825-000, which would bypass Washington Water Power Company.

A third proposal by Panhandle Eastern Pipe Line Company in Docket No. CP88-681-000 was originally filed under the prior notice procedures of the Commission's self-implementing blanket certificate program (18 C.F.R. § 157.205). Because a protest was recently filed by Michigan Consolidated Gas Company, however, Panhandle's proposal must now be processed under traditional section 7(c) procedures unless the protest is withdrawn or resolved. Panhandle's proposal to serve National Steel Corporation would bypass Michigan Consolidated.

The Commission also has pending a complaint by Kansas Power & Light Company in Docket No. CP88-42-000. KP&L complains that Williams Natural Gas Company is providing service to Atlas Power Company that is not authorized by William's existing certificate to serve Atlas. Williams argues that the service is authorized, but Williams also filed an application in Docket No. CP61-29-001 for a certificate amendment specifically recognizing the service in question.

The Commission also has pending before it proposals by Mojave Pipeline Company, Docket No. CP85-437-001; Kern River Gas Transmission Company, Docket No. CP85-552-001; and Wyoming-California Pipeline Company, Docket No. CP87-479-000, to transport gas for end users engaged in enhanced oil recovery. California distributors have opposed these applications on the grounds that they can serve the customers more economically. These proposal are not viewed generally as bypass cases. Although California distributors currently supply some gas to these customers, the proposals under consideration in these dockets are for service to incremental markets that have never been served and are not now being served by any distribution company.

Finally, there are three pending applications by interstate pipelines to provide service that would bypass other interstate pipelines. It is our understanding, however, that the Subcommittee is concerned only with transactions that would bypass local distribution companies.

(b) The application by Panhandle Eastern Pipeline Company mentioned above is the only pending bypass proposal under blanket certificate authorization. As indicated, however, it will not be processed under the Order 436/500 procedures unless the protest by Michigan Consolidated is withdrawn or resolved.

In addition, there are two pending complaints related to bypass under NGPA section 311 of the Natural Gas Policy Act (NGPA). Cascade Natural Gas Corporation filed a complaint in Docket No. CP88-286-000 alleging that Northwest Pipeline Corporation was bypassing Cascade by illegally transporting gas to Chevron Chemical Company under color of NGPA § 311. The Commission issued an order denying the complaint on July 19, 1988 (44 FERC ¶ 61,081), and the case is now pending on rehearing. Also, Oklahoma Natural Gas Company filed a complaint in Docket No. CP87-433-000 alleging that Williams Natural Gas Company's transportation of gas on behalf of Quivara Gas Company for delivery to Koch Industries, Inc. is in violation of NGPA § 311.

The notice and reporting procedures required by Order Nos. 436 and 500, though abbreviated, are adequate to inform the Commission that a particular proposal will result in bypassing a distributor. For instance, within thirty days after commencing transportation under a blanket certificate, a pipeline must file a full report with the Commission containing, among other things, a description of the transaction, the identity of the parties, and the points between which the gas is transported. 18 C.F.R. § 284.223(f) (1988). In order to construct new sales taps or to transport gas for periods larger than 120 days, pipelines operating under a blanket certificate must comply with the Commission's prior notice requirements. 18 C.F.R. §§ 284.221(f)(4) and 284.223(b) (1988). These provisions require that notice of the proposal be published in the Federal Register with a 45-day deadline for protests. 18 C.F.R. § 157.205(d) (1988). If no protests are filed, the transaction may proceed. If a protest is filed, the regulations provide for a 30-day period to resolve the protest. If the protest is not withdrawn or resolved within that period, then the transaction is treated as a traditional application under section 7 of the Natural Gas Act. 18 C.F.R. § 157.205(f) (1988).

The prior notice provisions require a company to file with the Commission a request for authorization that, among other things, identifies the shipper and contains a copy of the executed transportation agreement as well as a form of notice for publication in the Federal Register that "briefly summarizes the facts contained in the request with sufficient particularity so as to notify the public of its scope and purpose." 18 C.F.R. § 157.205(b).

In addition to transporting gas under a blanket certificate, pipelines also transport under the self-implementing provisions of the Commission's regulations implementing section 311(a)(1) of the Natural Gas Policy Act. 18 C.F.R. § 284.101-.106 (1988). These provisions do not require prior notice. However, they do require pipelines to file an initial full report with the Commission within thirty days after commencing transportation. Among other things, the report must include the identity of the parties to the transaction and

> If such transportation is provided to a customer that is located in the service area of a local distribution company, a statement that the interstate pipeline has notified the local distribution company's appropriate regulatory agency in writing of the proposed transportation prior to commencement.

18 C.F.R. § 284.106(a)(4) (1988).

Our experience is that these requirements have been sufficient to inform the Commission and the public of bypass transactions. For example, Michigan Consolidated's protest in Docket No. CP88-681-000 above was prompted by Panhandle's compliance with the prior notice procedures. Likewise, the application by Northern Natural in Docket No. CP88-540-000 was originally filed under the prior notice procedures but is being processed under section 7(c) because of protests by Iowa Public Service Company and others.

Question 2: When the Commission publishes a notice in the Federal Register that a pipeline seeks to provide blanket transportation service and construct facilities to serve an end user directly, does that notice clearly state that such service would bypass a public utility, and which public utility would be bypassed?

Answer: The notice procedures applicable to blanket transportation service and construction of the necessary delivery facilities are described above in response to Question No. 1(b).

Question 3: How many bypasses have been accomplished under NGPA section 311? Under traditional section 7(c) procedures? Under the optional expedited certificate procedures?

Answer: Except for the complaints by Cascade Natural Gas Corporation and Oklahoma Natural Gas Company mentioned above, the Commission staff is not aware of any other bypass transactions under NGPA § 311. Others may have been performed, but if so they have not given rise to any complaints before the Commission.

Since 1984, when bypass became an issue, the Commission has approved three proposals under the traditional section 7(c) procedures to bypass local distribution companies. The three cases were:

(1) a proposal by Panhandle to serve National Steel, bypassing Michigan Consolidated (Opinion No. 275-A, 40 FERC ¶ 61,220 (1987); Opinion No. 275-B, 42 FERC ¶ 61,076 (1988)),

(2) a proposal by American Distribution Company (Alabama Division) to serve Kerr-McGee Chemical Corporation, bypassing Mobile Gas Service Corporation (37 FERC ¶ 61,282 (1986)), and

(3) a proposal by Panhandle to serve Hayes-Albion Corporation, bypassing Southeastern Michigan Gas Company (29 FERC ¶ 61,338 (1984), reh'g denied, 31 FERC ¶ 61,333 (1988)).

To date the Commission has not approved any proposals to bypass a local distribution company under the optional expedited certificate procedures.

Question 4: When a pipeline constructs facilities to transport under blanket certificate authorization or under NGPA section 311, how does the Commission ensure that its environmental responsibilities under NEPA are satisfied?

Answer: Any construction pursuant to a blanket certificate must comply with the environmental requirements of 18 C.F.R. § 157.206. Section 284.11 of the Commission's regulations applies the same requirement to construction under section 311. The provisions of § 157.206 are comprehensive. They preclude any construction at all that would have an adverse impact on a sensitive environmental area (18 C.F.R. § 157.206(d)(4) (1988)) and further require all activities to be consistent with all applicable environmental laws and with stringent construction guidelines set forth in 18 C.F.R. § 2.69 (1988). Copies of §§ 157.206 and 2.69 are attached.

(d) *National rate for pipeline or pipeline affiliate production from wells commenced prior to January 1, 1973.* Notwithstanding any other provision of this § 2.66, natural gas production from a lease owned by a pipeline company or a pipeline affiliate may be priced for ratemaking purposes at the rate prescribed in § 2.56B(a)(1) of this part if such production qualifies under the provisions set forth in § 2.56B(a)(2) of this part, if such lease was acquired after October 7, 1969.

(e) *Inapplicability to certain gas produced on or after December 1, 1978.* This section does not apply to natural gas produced on or after December 1, 1978. As to that gas, § 154.42 is applicable.

(Natural Gas Act, 4, 5, and 8; 15 U.S.C. 717c, 717d, 717g (1982))

[34 FR 17804, Nov. 15, 1969, as amended at 35 FR 1104, Jan. 28, 1970; Opinion 749–A, 41 FR 9867, Mar. 8, 1976; Opinion 770–A, 41 FR 50233, Nov. 15, 1976; Order 98, 45 FR 53098, Aug. 11, 1980; Order 391, 49 FR 33858, Aug. 27, 1984]

§ 2.67 Calculation of taxes for property of pipeline companies constructed or acquired after January 1, 1970.

Pursuant to the provisions of section 441(a)(4)(A) of the Tax Reform Act of 1969, 83 Stat. 487, 625, natural gas pipeline companies which have exercised the option provided by that section to change from flow through accounting will be permitted by the Commission, with respect to liberalized depreciation, to employ a normalization method for computing Federal income taxes in their accounts and annual reports with respect to property constructed or acquired after January 1, 1970, to the extent to which such property increases the productive or operational capacity of the utility and is not a replacement of existing capacity. Such normalization will also be permitted for ratemaking purposes. As to balances in Account No. 282 of the Uniform System of Accounts, "Accumulated deferred income taxes—Other property," it will remain the Commission's policy to deduct such balances from the rate base of natural gas pipeline companies in rate proceedings.

(Secs. 3, 4, 5, 8, 9, 10, 15, 16, 301, 304, 308, and 309 (41 Stat. 1063–1066, 1068, 1072, 1075; 49 Stat. 838, 839, 840, 841, 854–856, 858–859; 52 Stat. 822, 823, 825, 826; 76 Stat. 72; 82 Stat. 617; 16 U.S.C. 796, 797, 803, 808, 809, 816, 825, 825b, 825c, 825g, 825h, 826i); as amended, secs. 8, 10, and 16 (52 Stat. 825–826, 830; 15 U.S.C. 717c, 717d, 717g, 717h, 717i, 717o))

[Order 404, 35 FR 7964, May 23, 1970, as amended by Order 567, 42 FR 30612, June 16, 1977]

§ 2.69 Guidelines to be followed by natural gas pipeline companies in the planning, locating, clearing and maintenance of rights-of-way and the construction of aboveground facilities.

(a) In the interest of preserving scenic, historic, wildlife and recreational values, the construction and maintenance of facilities authorized by certificates granted under section 7(c) of the Natural Gas Act should be undertaken in a manner that will minimize adverse effects on these values. Accordingly, the Commission believes that the planning, locating, clearing and maintenance of rights-of-way and the construction of aboveground facilities should, as a general practice, conform to the guidelines set forth below. The National Environmental Policy Act of 1969, Pub. L. 91-190, 83 Stat. 852, title I, section 102 thereof, directs agencies of the Federal Government to utilize a systematic, interdisciplinary approach which will insure integrated use of the natural and social sciences and the environmental design arts in planning and in decisionmaking which may have an impact on man's environment. Congress has declared as a national policy the critical importance of restoring and maintaining environmental quality and directed that all practicable means be used to create and maintain conditions under which man and nature can exist in productive harmony, and fulfill the social and economic requirements of present and future generations of Americans. There is increasing need to fit the construction of pipeline facilities into an overall plan for land development and use in Federal, State, and regional land use planning and development. While these guidelines would require greater advance planning and earlier filing of applications than has been the past practice, it is clear that such earlier planning and filing would generally result in minimizing the time delay caused by considering location as part of an overall plan for land development and use. To the extent landowners may have special interests concerning the planning, locating, clearing and maintenance of rights-of-way and the construction of aboveground facilities on their property, those desires may be taken into account by natural gas companies so long as the result is consistent with local laws relating to land use. These guidelines do not affect an applicant's obligation to comply with the applicable safety regulations of the Department of Transportation, pursuant to the Natural Gas Pipeline Safety Act of 1968.

(1) *Pipeline construction.* (i) In locating proposed facilities, consideration should be given to the utilization, enlargement or extension of existing rights-of-way belonging to either applicant or others, such as pipelines, electric powerlines, highways, and railroads.

(ii) Where practical, rights-of-way should avoid the national historic places listed in the National Register of Historic Places and natural landmarks listed in the National Register of Natural Landmarks maintained by the Secretary of the Interior, and parks, scenic, wildlife, and recreational lands, officially designated by duly constituted public authorities. If rights-of-way must be routed through such historic places, parks, wildlife, or scenic areas, they should be located in areas or placed in a manner so as to be least visible from areas of public view and so far as possible in a manner designed to preserve the character of the area.

(iii) Rights-of-way should avoid heavily timbered areas and steep slopes, where practical.

(iv) Right-of-way clearings should be kept to the minimum necessary width to prevent interference of trees or other vegetation with the construction of proposed transmission facilities.

(v) The method of clearing rights-of-way should take into account matters of soil stability, protection of natural vegetation and the protection of adjacent resources.

(vi) Trees and other vegetation cleared from rights-of-way in areas of public view should be disposed of without undue delay. In all phases of construction, including burning of debris, such measures shall be taken for the prevention and control of fire and other hazards as are required by applicable law and regulations. Tree stumps which are adjacent to roads and other areas of public view should be cut close to the ground or removed.

(vii) Trees and shrubs which are not cleared should not be unnecessarily damaged during construction.

(viii) Efforts should be made to avoid clearance of rights-of-way to the mineral soil, except in the ditch itself. Where this does occur in scattered areas of the rights-of-way, the surface should be restored and stabilized without undue delay.

(ix) Soil which has been excavated during construction and not used should be evenly filled back onto the cleared area or removed from the site. The soil should be graded to comport with terrain of the adjacent land and vegetation planted and fertilized, where appropriate.

(x) Terraces and other erosion control devices should be constructed where necessary to prevent soil erosion on slopes on which rights-of-way are located.

(xi) Where rights-of-way cross streams and other bodies of water, the banks should be stabilized to prevent erosion. Construction on rights-of-way should be conducted in such manner as to keep to a minimum damage to shorelines, recreational areas and fish and wildlife habitats.

(xii) Replacement of earth adjacent to water crossings should be at slopes equal to or less than the normal angle of response for the soil type involved and sandbagging, seeding, or other methods of soil stabilization should be accomplished without undue delay.

(xiii) Blasting should not be done within or near stream channels without prior consultation with Federal and State conservation authorities having jurisdiction to determine what protective measures should be taken to minimize damage to fish and other aquatic life.

(xiv) Any potholes, marshes or similar water areas drained to facilitate construction should be reestablished to their preconstruction water levels and flow characteristics following completion of construction, if such reestablishment is consistent with landowner wishes.

(xv) Cofferdam or other diversionary techniques to lay pipe across streams should be used where necessary and practical to permit flow in one part of the stream while construction work is being performed in another part.

(xvi) Care should be taken to avoid oil spills and other types of pollution while work is performed in streams and other bodies of water and in their immediate drainage areas.

(xvii) Water used for pipeline testing taken from streams or other bodies of water should be taken in such manner as to minimize harm to the ecology, fish and wildlife resources, or aesthetic values of the areas. When testing water is released, it should be done in such a manner as not to cause erosion and siltation or damage to the ecology of the area.

(xviii) Excess construction materials and other debris should be removed from the right-of-way or otherwise suitably disposed of.

(xix) In wooded areas long views of cleared rights-of-way, visible from highways and other areas of public view, should be avoided. The rights-of-way alignment of these locations should be deflected before entering and leaving highways and areas of public view where such deflection is consistent with safe and sound engineering practice and accomplishes the desired results.

(xx) Where practical, rights-of-way should not cross hills and other high points at the crests, particularly where such crossing is in forested areas and clearly visible from highways and other areas of public view. When they must do so the alignment should be deflected near the crests where such deflection is consistent with safe and sound engineering practice and accomplishes the desired result of eliminating the notch in the tree line at the crests.

(xxi) Where rights-of-way enter dense timber from a meadow or other clearing and where such entrance is visible from highways and other areas of public view, screen planting should be employed.

(xxii) Temporary roads used for construction should be designed for proper drainage and built in such manner as to minimize soil erosion. Upon abandonment, such roads should be stabilized without undue delay.

(2) *Right-of-way maintenance.* (i) Once a cover of vegetation has been established on a right-of-way, it should be properly maintained.

(ii) Access roads and service roads should be maintained with proper cover, water bars and the proper slope in order to minimize soil erosion. They should be jointly used with other utilities and land management agencies where practical.

(iii) When chemicals are used for weed control, they should be applied at such time and in such manner as to minimize the impact of temporary discoloration of the foliage. Care should be taken to assure that chemicals used to control the growth of tree stumps do not damage the vegetation or add to water or soil pollution.

(iv) During inspection of rights-of-way attention should be given to locate gullies and fallen timber and to observe the condition of the vegetation. The use of aircraft to inspect and maintain rights-of-way should be encouraged.

(3) *Construction of aboveground appurtenant facilities.* (i) The proposed exterior plans and location of compressor stations and other aboveground facilities, including meter and regulator stations and communication towers, should be made appropriately available to local agencies which have jurisdiction.

(ii) Unobstrusive sites should be selected where practical for the location of aboveground facilities.

(iii) Potential noise should be considered when the location for compressor stations is being determined. Such facilities should be located in areas where sound resonation would be minimal; consideration should be given to the use of accoustical treatment as a further means of noise abatement.

(iv) The size of aboveground facilities should be kept to the minimum feasible.

(v) The exterior of compressor stations and other aboveground facilities, to the extent consistent with the functional needs and economic feasibility of construction of such facilities, should not unduly detract from the surroundings and other buildings in the area.

(vi) In areas adjacent to such aboveground facilities, trees and shrubs should be planted, or other appropriate landscaping installed, in order to enhance the appearance of such facilities, consistent with operating needs.

(vii) Storage tanks should be placed below ground where technology and economics make it feasible.

(viii) Yards and surrounding areas should be kept clean and free of unused or discarded materials.

(ix) The design and operation of aboveground facilities should conform to applicable air and water quality standards.

(Secs. 7(c), 7(e), 52 Stat. 825, 56 Stat. 83, 84; 15 U.S.C. 717(c), 717f(e); Pub. L. 96-511, 94 Stat. 2812 (44 U.S.C. 3501 *et seq.*))

[Order 407, 35 FR 11389, July 16, 1970]

§ 2.70 Measures for the protection of reliable and adequate natural gas service.

(a) This Commission, charged with the responsibility for natural gas reliability, hereby promulgates as a statement of general policy that jurisdictional pipeline companies shall take all steps necessary for the protection of as reliable and adequate service as present supplies and capacities will permit during the 1971-72 heating season and thereafter, including adequate injection into storage in anticipation of the heating season.

(b) In order to effectuate the foregoing:

(1) During the storage injection season all natural gas pipelines subject to the jurisdiction of the Commission should make every reasonable effort to fill all storage fields supplied by such pipelines to a capacity sufficient to meet the anticipated heating season demands.

(2)(i) All jurisdictional pipelines will within 30 days hereof, submit a written report (four copies) to the Secretary of the Commission indicating how the instant statement of policy will be implemented. Pipelines responding that curtailment will be necessary will file a tariff sheet, pursuant to sections 4 and 5 of the Natural Gas Act and the Commission's regulations thereunder, setting forth a curtailment plan to effectuate the instant policy or state that the curtailment program, if any, currently on file will effectuate this policy. The curtailment plan proposed may be divided between the injection season and the heating season, since different objectives may require different treatment.

(ii) Consideration should be given to the curtailment of volumes equivalent to all interruptible sales and to the curtailment of large boiler fuel sales where alternate fuels are available.

(3) The Commission, recognizing that additional short-term purchases of natural gas may be necessary to meet a pipeline's system demands for the immediate future, will continue the sixty (60) day emergency sales commenced under § 157.29 (18 CFR 157.29) pursuant to the certification provisions of this subsection. If a pipeline demonstrates continued emergency need, after complying with paragraphs (b) (1) and (2) of this section, the Commission will consider authorizing the pipeline to make gas purchases for a limited term at a rate above the national rate level prescribed in § 2.56(h) (18 CFR 2.56(h)) and will authorize abandonment of the sale at the time the certificate is issued if the same is demonstrated to be in the public interest: *Provided, however,* The certification authority set forth in this section shall apply to sales of natural gas from the offshore Federal domain only where the sales are made at the rate prescribed in § 2.56(h).

(4) Where emergency gas purchases are made and/or a curtailment program is instituted to implement the above policy the pipeline should place, or already have in effect, volumetric limitations on sales at current levels.

(5) Notice should be taken that the Commission will reexamine existing commodity rate levels and, to the

Subsection (f), appearing in 47 F.R. 24254 (6/4/82), effective 7/6/82, was redesignated subsection (g) in 53 F.R. 15374 (4/29/88), effective 5/31/88.

Subsection (g), appearing in 47 F.R. 24254 (6/4/82), effective 7/6/82, read as follows until its amendment in 47 F.R. 38871 (9/3/82), effective 8/31/82:

(g) *Withdrawal of protests.* The protestor may withdraw a protest within the 30 day period following the deadline determined in accordance with paragraph (d) of this section by submitting written notice of withdrawal to the Secretary of the Commission and serving a copy to the certificate holder, any intervenors and any other party requesting service. The withdrawal must state that the certificate holder, the protestor, all intervenors and staff concur in the withdrawal.

Subsection (g), appearing in 47 F.R. 38871 (9/3/82), effective 8/31/82, was redesignated subsection (h) in 53 F.R. 15374 (4/29/88), effective 5/31/88.

Subsection (h), appearing in 47 F.R. 24254 (6/4/82), effective 7/6/82, read as follows until its amendment in 50 F.R. 42408 (10/18/85), effective 11/18/85:

(h) *Final authorization.* (1) If no protest is filed within the deadline prescribed by the Secretary, the certificate holder shall be deemed to be authorized to conduct the activity under its blanket certificate, effective upon the day after the deadline established by the Secretary.

(2) If one or more protests are filed within the deadline but subsequently withdrawn pursuant to paragraph (g) of this section, the certificate holder shall be deemed to be authorized to conduct the activity under its blanket certificate, effective upon the day after the withdrawal of all protests.

Subsection (h), appearing in 50 F.R. 42408 (10/18/82), effective 11/18/88, was redesignated subsection (i) in 53 F.R. 15374 (4/29/88), effective 5/31/88.

[¶ 19,636]

§ 157.206 Standard conditions.

Any activity authorized under a blanket certificate issued under this subpart is subject to the following conditions:

(a) *Revisions.* (1) The Commission reserves the right to amend the requirements of this subpart from time to time.

(2) The blanket certificate is not transferable in any manner and shall be effective only so long as the certificate holder continues the activities authorized by the order issuing such certificate and does so in accordance with the provisions of the Natural Gas Act, as well as applicable rules, regulations, and orders of the Commission.

(b) *Production-related costs.* At such time as the certificate holder proposes to recover in its rates any costs incurred by it to compress, process, treat, or gather natural gas purchased or transported by it, the certificate holder may be required to prove that the activity which engendered those costs was prudent. In determining prudence, the Commission will apply the statement of policy set out under § 2.102 of this chapter.

(c) *Liquids, liquefiable hydrocarbons and non-hydrocarbon constituents.* To the extent that the certificate holder transports liquids and liquefiable hydrocarbons or non-hydrocarbon constituents other than natural gas which are ultimately removed from the natural gas stream pursuant to the blanket certificate, or uses facilities authorized by the blanket certificate for the transportation of such substances, the issuance of the blanket certificate is without prejudice to a determination of the proper apportionment of costs between:

(1) The transportation and handling of liquids and liquefiable hydrocarbons or non-hydrocarbon constituents which are ultimately removed from the gas stream; and

(2) The transportation and handling of natural gas; at the time that the certificate holder files to include in its natural gas rates the costs associated with the facilities or the activities authorized herein, or in any proceeding where the apportionment of the certificate holder's costs to liquids and liquefiable hydrocarbons or non-hydrocarbon constituents is at issue.

(d) *Environmental compliance.* (1) The certificate holder shall adopt the guidelines set forth in § 2.69 of this chapter for all activities authorized by the blanket certificate and shall issue the relevant portions thereof to construction personnel, instructing them to use these guidelines.

(2) All activities shall be consistent with all applicable law including the provisions of the following statutes and regulations or compliance plans developed to implement these statutes:

(i) Clean Water Act, as amended (33 U.S.C. 1251 *et seq.*) and the National Pollution Discharge Elimination System Program, 40 CFR Part 122 *et seq.*;

(ii) Clean Air Act, as amended (42 U.S.C. 1801 *et seq.*) and air quality regulations and state implementation plans adopted pursuant to 40 CFR Parts 50—99;

(iii) National Historic Preservation Act of 1966 (16 U.S.C. 470 *et seq.*);

(iv) Archeological and Historic Preservation Act of 1974 (Pub. L. No. 93—291);

(v) Coastal Zone Management Act of 1972, as amended (16 U.S.C. 1451 *et seq.*);

(vi) Endangered Species Act of 1973, Pub. L. No. 93—205, as amended (16 U.S.C. 1531 *et seq.*);

(vii) Executive Order 11,988, May 24, 1977 requiring Federal agencies to evaluate the potential effects of any actions it may take on a floodplain;

(viii) Executive Order 11,990, May 24, 1977 requiring an evaluation of the potential effects of construction on wetland;

(ix) Wild and Scenic Rivers Act (16 U.S.C. 1274 *et seq.*);

(x) National Wilderness Act (16 U.S.C. 1133 *et seq.*);

(xi) National Parks and Recreation Act of 1978 (16 U.S.C. 1 and 230 *et seq.*).

(3) The certificate holder shall be deemed in compliance with:

(i) Paragraph (d)(2)(vi) of this section only if it adheres to the procedures in Appendix I of this subpart in which case the Commission finds that endangered species and their critical habitat are protected in accordance with 16 U.S.C. 1536;

(ii) Paragraph (d)(2)(iii) of this section only if it adheres to the procedures in Appendix II of this subpart in which case the Commission finds that there is no effect on any property protected by 16 U.S.C. 470f;

(iii) Paragraph (d)(2)(v) of this section only if the appropriate state agency designated to administer the state's coastal zone management plan, prior to construction of the project, waives its right of review or determines that the project complies with the state's coastal zone management plan.

(4) Any transaction authorized under a blanket certificate shall not have a significant adverse impact on a sensitive environmental area.

(5) The noise attributable to any compressor facility installed pursuant to the blanket certificate shall not exceed a day-night sound level (L_{dn}) of 55 dB (A) at any noise-sensitive area unless the noise-sensitive areas (such as schools, hospitals, or residences) are established after facility construction.

(6)(i) Any activity otherwise subject to authorization under § 157.208 shall not be authorized if the activity is located within 0.5 mile of a nuclear power plant which is either operating or under construction, or for which a construction permit has been filed with the Nuclear Regulatory Commission.

(ii) Any activity otherwise subject to authorization under § 157.215 shall not be authorized if the activity is located within 2.0 miles of a nuclear power plant which is either operating or under construction, or for which a construction permit has been filed with the Nuclear Regulatory Commission.

(7) The certificate holder shall act as the Commission's non-Federal representative upon acceptance of the blanket certificate for purposes of complying with the Endangered Species Act of 1973.

(e) *Budget-type certificates.* Upon the acceptance of a certificate issued pursuant to this subpart, the certificate holder shall surrender any currently effective budget-type certificate issued pursuant to § 157.7 of this Part.

(f) *Commencement.* Any authorized construction, extension, or acquisition shall be completed and in actual operation by the certificate holder and any authorized operation, service or sale shall be actually undertaken within one year of the date the activity is authorized pursuant to § 157.205(h). The certificate holder may apply to the Director of the Office of Pipeline and Producer Regulation for an extension of this deadline.

(g) *Reports.* The certificate holder shall file reports as required by this subpart.

(h) *Treatment of revenues.* (1) Except as provided in paragraph (h)(2) and (3) of this section, all revenues received for storage services authorized under § 157.213 or for sales for resale authorized under § 157.210 in excess of an allowance of one cent per MMBtu shall be credited to Account No. 191 and flowed back to the certificate holder's customers.

(2) A certificate holder is not required to credit revenues to Account No. 191 pursuant to paragraph (h)(1) of this section:

(i) If representative levels of revenues attributable to such services have been credited in arriving at a test period cost of service; or

(ii) If representative levels of volumes for such services have been included in billing determinants for the purposes of establishing rates.

(3) The certificate holder may elect to forego the one cent per MMBtu allowance provided in paragraph (h)(1) of this section. If the certificate holder so elects, it is not required to credit to Account No. 191 any amount which, upon application, is demonstrated to represent the out-of-pocket expenses of the certificate holder in connection with a transaction authorized under this subpart.

.01 Introductory text, 50 F.R. 42408 (October 18, 1985); subsections (a)-(c), 47 F.R. 24254 (June 4, 1982); subsection (d), 47 F.R. 38871 (September 3, 1982); subsections (e)-(g), 47 F.R. 24254 (June 4, 1982); subsection (h), 50 F.R. 42408 (October 18, 1985).

.05 *Historical record.*—Section 157.206 originated in 47 F.R. 24254 (6/4/82), effective 7/6/82.

The introductory clause to section 157.206, appearing at 47 F.R. 24254 (6/4/82), effective 7/6/82, read as follows until its amendment in 50 F.R. 42408 (10/18/85), effective 11/18/85:

Any activity authorized under a blanket certificate issued pursuant to this subpart shall be subject to the following conditions:

Subsection (d), appearing in 47 F.R. 24254 (6/4/82), effective 7/6/82, read as follows until it was amended in 47 F.R. 38871 (9/3/82), effective 8/31/82:

(d) *Environmental compliance.* (1) The certificate holder shall adopt the guidelines set forth in § 2.69 of this chapter for all activities authorized by the blanket certificate and shall issue the relevant portions thereof to construction personnel, instructing them to use these guidelines.

(2) All activities shall be consistent with all applicable law including the provisions of the following statutes and regulations or compliance plans developed to implement these statutes:

(i) Clean Water Act, as amended (33 U.S.C. 1251 *et seq.*) and the National Pollution Discharge Elimination System Program, 40 CFR Part 122 *et seq.*;

(ii) Clean Air Act, as amended (42 U.S.C. 1801 *et seq.*) and air quality regulations and state implementation plans adopted pursuant to 40 CFR Parts 50—99;

(iii) Safe Drinking Water Act, as amended (42 U.S.C. 300f *et seq.*);

(iv) National Historic Preservation Act of 1966 (16 U.S.C. 470 *et seq.*);

(v) Archeological and Historic Preservation Act of 1974 (Pub. L. No. 93—291);

(vi) Coastal Zone Management Act of 1972, as amended (16 U.S.C. 1451 *et seq.*);

(vii) Endangered Species Act of 1973, Pub L. No. 93—205, as amended (16 U.S.C. 1531 *et seq.*);

(viii) Executive Order 11,988, May 24, 1977 requiring Federal agencies to evaluate the potential effects of any actions it may take on a floodplain;

(ix) Executive Order 11,990, May 24, 1977 requiring an evaluation of the potential effects of construction on wetland;

(x) Wild and Scenic Rivers Act (16 U.S.C. 1274 *et seq.*);

(xi) National Wilderness Act (16 U.S.C. 1133 *et seq.*);

(xii) National Parks and Recreation Act of 1978 (16 U.S.C. 1 and 230 *et seq.*).

(3) The certificate holder shall be deemed in compliance with:

(i) Paragraph (d)(2)(vii) of this section only if it adheres to the procedures in Appendix I of this subpart in which case the Commission finds that endangered species and their critical habitat are protected in accordance with 16 U.S.C. 1536;

(ii) Paragraph (d)(2)(iv) of this section only if it adheres to the procedures in Appendix II of this subpart in which case the Commission finds that there is no effect on any property protected by 16 U.S.C. 470f;

(iii) Paragraph (d)(2)(vi) of this section only if the appropriate state agency designated to administer the state's coastal zone management plan, prior to construction of the project, waives its right of review or determines that the project complies with the state's coastal zone management plan.

(4) Any transaction authorized under a blanket certificate shall not significantly impact or adversely affect a sensitive environmental area.

(5) The noise attributable to any compressor facility installed pursuant to the blanket certificate shall not exceed a day-night sound level (L_{dn}) of 55 dB (A) at any noise-sensitive area unless the noise-sensitive areas (such as schools, hospitals, or residences) are established after facility construction.

(6)(i) Any activity otherwise subject to authorization under § 157.208 shall not be authorized if the activity is located within 0.5 mile of a nuclear power plant which is either operating or under construction, or for which a construction permit has been filed with the Nuclear Regulatory Commission.

(ii) Any activity otherwise subject to authorization under § 157.215 shall not be authorized if the activity is located within 2.0 miles of a nuclear power plant which is either operating or under construction, or for which a construction permit has been filed with the Nuclear Regulatory Commission.

(7) The certificate holder shall act as the Commission's non-Federal representative upon acceptance of the blanket certificate for purposes of complying with the Endangered Species Act of 1973.

Subsection (h) newly originated in 48 F.R. 34875 (8/1/83), effective 8/5/83, and read as follows until its amendment in 50 F.R. 42408 (10/18/85), effective 11/18/85:

(h) *Treatment of revenues.* (1) Except as provided in paragraphs (h)(2) and (3) of this section, all revenues received for transportation (including storage service) or for sales for resale authorized under the blanket certificate in excess of the sum of

(i) An allowance of one cent per MMBtu, and

(ii) The AIC per MMBtu that may be collected pursuant to § 157.209(f) for end-user transportation, shall be credited to Account No. 191 and flowed back to the certificate holder's customers.

(2) A certificate holder is not required to credit revenues to Account No. 191 pursuant to paragraph (h)(1) of this section:

(i) If representative levels of revenues attributable to such services have been credited in arriving at a test period cost of service; or

(ii) If representative levels of volumes transported have been included in billing determinants for the purpose of establishing rates.

A certificate holder that treats end-user transportation revenues in accordance with this subparagraph may not elect to collect an AIC authorized in § 157.209(f).

(3) The certificate holder may elect to forego the one cent per MMBtu allowance provided in paragraph (h)(1) of this section. In such a case the certificate holder is not required to credit to Account No. 191 any amount which, upon application, the Commission finds to have been demonstrated as representing the out-of-pocket expenses of the certificate holder in connection with a transaction authorized under this Subpart.

[¶ 19,637]

§ 157.207 General reporting requirements.

On or before May 1, of each year, the certificate holder must file in the manner prescribed in §§ 157.6(a) and 385.2011 of this chapter an annual

APPENDIX II

Additional Material Submitted for the Record

ALAN K. SIMPSON
WYOMING

ASSISTANT REPUBLICAN
LEADER

VETERANS' AFFAIRS COMMITTEE

JUDICIARY COMMITTEE
Ranking Minority—Subcommittee on
Immigration and Refugee Policy

ENVIRONMENT AND PUBLIC WORKS COMMITTEE
Ranking Minority—Subcommittee on
Nuclear Regulation

United States Senate
WASHINGTON, DC 20510

October 3, 1988

Honorable John Breaux
United States Senate
Washington, D.C. 20510

Dear John:

We are so very concerned about your proposed legislation, S. 1998, which would significantly inhibit the opportunity for natural gas producers and pipeline companies to sell their product directly to end users.

We strongly fear that this attempt to protect or shelter one sector of the gas industry will undo years of progress in our effort to deregulate and inject greater competition into it. We are aware of the concern that competitive sales directly to the end users could potentially result in increased rates to residential consumers. However, by legislatively interfering in the FERC process, your bill would certainly deny these natural gas consumers -- and the producers -- the opportunity to seek the most economical and efficient means of transportation. This would set back years of painstaking effort to achieve open access in pipeline transportation and marketing opportunities. The ability to circumvent anti-competitive local distributing companies has long been an important element in negotiating fair rates between producers, pipelines and local distributing companies. Your bill would obviously interfere in this negotiating process and would ultimately serve to benefit no one -- including residential consumers.

Beyond the negative impact S. 1998 -- or Senator Cranston's bill, S. 2313 -- would have on the entire nation, certainly one of our greatest concerns focuses on the proposed natural gas pipeline from southwestern Wyoming to the enhanced oil recovery fields in southern California. This proposed pipeline would create many additional markets for Wyoming's gas. It is therefore a top priority for our State and all of its elected officials -- Democrat and Republican alike. It is our hope you will communicate with Wyoming's fine Democratic Governor, Mike Sullivan. We trust you will find his views on this issue to be quite interesting.

We must inform you, John, that we will do everything in our power to thwart this effort to prohibit this opportunity which is so important for our State in these troubling economic times. We, like your fine State of Louisiana, have suffered hideously by the depressed prices in oil and gas, and we look upon the aforementioned pipeline as a very critical step on the road to recovery. Therefore, we will strongly oppose any legislative or administrative effort to derail the progress that we and the Federal Energy Regulatory Commission have made toward achieving open access.

We know you are understanding of our concerns and we appreciate your consideration of them.

With best personal regards,

Sincerely,

Malcolm

Malcolm Wallop
United States Senator

Alan K. Simpson
United States Senator

cc: Honorable Howard Metzenbaum
Honorable Don Nickles
Honorable Alan Cranston
Chairman Martha Hesse
Honorable Mike Sullivan

HELLER, EHRMAN, WHITE & McAULIFFE
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MICHAEL C. DOTTEN, P.C.
PARTNER

September 28, 1988

The Honorable Howard M. Metzenbaum
Chaiman, Subcommittee on Energy Regulation
and Conservation
Committee on Energy and Natural Resources
United States Senate
212 Senate Hart Office Building
Washington, D.C. 20510-6150

Re: S. 2313 and S. 1998--"Anti-by-pass" Legislation

Dear Senator Metzenbaum:

This letter is written on behalf of the undersigned companies in opposition to two bills that will be the subject of hearings before the Subcommittee on Energy Regulation and Conservation. The bills, S. 2313 and S. 1998, are known as "anti-by-pass" legislation.

In the early part of this century, the states sanctioned utility monopolies only because it was believed that each and every customer would achieve lower priced service because of the economies of scale available to the monopoly utility. Today, local gas distribution companies (LDCs) have abandoned cost of service based pricing in favor of subsidizing commercial and residential rates. The result in many instances is that it is now cheaper for an industrial customer to build its own distribution lines and directly interconnect with an interstate pipeline than it is to remain on a LDC's system. The construction of a line to by-pass another line which has adequate capacity is indeed economic waste. But the answer to this waste is not to penalize the industrial customer by blocking access to the pipelines. The answer is to permit economic competition to force the LDCs to design their rates more nearly to match the cost of providing service to industrial customers. Otherwise our system of regulated monopolies becomes a system of captive and unwilling industrial customers, victimized by LDC monopolies with the blessing of the states. If S. 2313 or S. 1998 are passed, Congress would be aiding and abetting this abuse of monopoly power.

Both bills that are before the Subcommittee would insulate LDC monopolies. Each would do so in the guise of economic efficiency. S. 1998 goes so far as to suggest that the legislation will "help assure fair competition between interstate pipelines and local distribution companies." In fact, the central object of both bills is to prevent LDCs from having to adopt cost based natural gas transportation by shielding them from competing with interstate pipelines. In many instances by-passing the LDC is the only way for an industrial customer to obtain economically viable gas service.

The Subcommittee might fairly ask, "Aren't the state regulatory agencies sufficient protection against abuse of utilities' monopoly power?" Unfortunately, the answer is "no." State agencies have encouraged the development of subsidies by industrial customers of commercial and residential customers. Unlike the Federal Energy Regulatory Commission, they are not as mindful of the needs of interstate commerce or international trade. They often do not see industrial customers as competitors struggling in international commerce. Instead they see industrial customers as deep pockets able to bear a disproportionate share of energy cost increases. Often it is only when faced with the reality of by-pass that the states will permit the LDCs to develop rates that make the industrial customer indifferent to the by-pass option.

A second reason for permitting the by-pass option to continue is to permit industries to seek more reliable service. With wellhead price deregulation, interstate pipeline deregulation and relief of LDCs from existing contracts for gas supplies, LDCs are given every incentive to have under contract supplies of gas adequate only to serve their "core" (commercial and residential) customers. Industrial customers will increasingly face supply curtailments. Furthermore, as LDCs move more gas for increasing core customer loads, service will almost certainly become less reliable for industrial customers. In many instances direct connection with an interstate pipeline may upgrade the level of service (i.e. minimize the curtailments) an industrial customer faces. Therefore, the availability of by-pass to receive higher quality service may serve as an inducement to LDCs to keep industrial service reliable.

The situation in the Northwest leaves especially few options to industrial customers. Unlike other parts of the country where there are multiple competing pipelines serving industrial areas, there is but one pipeline serving the largest cities in Oregon, Washington and Idaho. Prohibition of LDC by-pass would only further reduce industrial customer's options in the Northwest and further subject them to abuse of monopoly power.

Utility monopolies were sanctioned by the law only as a means of helping consumers to receive lower rates. These monopolies should not now be sanctioned as jailers who can keep unwilling customers from going to competitors who are capable of providing more reliable service or cheaper rates.

We urge that the Subcommittee reject the insulation of monopolies by refusing to endorse either S. 1998 or S.2313.

Thank you for the opportunity to file these comments. We ask that they be made part of the hearing record.

Respectfully submitted,

Michael Dotten
Michael C. Dotten
Attorney for the undersigned industries with plants in the indicated locations

Thomas B. Boklund by MCD
Thomas B. Boklund
President
Oregon Steel Mills, Inc.
[Portland, Oregon and Napa, California]

George Wells by MCD
George Wells
President
Ash Grove Cement West, Inc.
[Portland, Oregon; Inkom, Idaho; Durkee, Oregon; Seattle, Washington]

Michael T. Bogdan by MCD
Michael T. Bogdan
Purchasing Manager
Willamette Industries, Inc.
[multiple plant locations in Oregon, Washington, California and other regions of the United States]

Philip J. Friedman by NWD

Philip J. Friedman
General Manager of
Manufacturing
ESCO Corporation
[Portland, Oregon: Newton, Mississippi and multiple international locations]

Thomas F. Zelenka by NWD

Thomas F. Zelenka
Manager, Governmental and
Legislative Affairs
Schnitzer Steel Industries
[Portland, Oregon; McMinnville, Oregon (Cascade Steel Rolling Mills, Inc.) and multiple sales and service locations]

Bruce Johnson by NWD

Bruce Johnson
Chief Engineer
Columbia Steel Castings Co., Inc.
[Portland, Oregon]

STATEMENT OF
JEFF ENGLISH,
CITY MANAGER AND NATURAL GAS OPERATIONS MANAGER,
CITY OF WRENS, GEORGIA,
ON BEHALF OF THE
AMERICAN PUBLIC GAS ASSOCIATION
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
UNITED STATES SENATE
ON S. 2313 AND S. 1998

September 29, 1988

EXECUTIVE SUMMARY

The American Public Gas Association ("APGA") supports enactment of S. 2313, legislation introduced by Senator Alan Cranston (D-CA), that would limit the Federal Energy Regulatory Commission's ("FERC") power to authorize physical bypass of local distribution companies ("LDCs") by interstate pipelines and larger end users of natural gas and would return to the state and local regulatory bodies the authority to determine whether bypass is in the public interest. Since it is imperative that legislation effectively dealing with this serious problem be enacted as soon as possible, APGA also supports the passage of S. 1998, introduced by Senator John Breaux (D-LA), which would allow state regulatory commissions, municipalities and LDCs to petition the FERC for an order prohibiting bypass by interstate pipelines.

A national policy of permitting bypass of LDCs' facilities would have a detrimental impact on the remaining residential, commercial, and industrial consumers and on the continued viability of the LDCs themselves. Such a policy would permit pipelines to engage in "cream-skimming," whereby pipelines could offer gas service to large, high load factor customers at a lower price than the distributor is able to offer.

This savings for the bypassing end user can only be accomplished by the shifting of that customer's share of the LDC's costs to the LDC's other customers or to the LDC itself. In other words, the bypassing end user's rates will be reduced through a forced subsidy borne by others. In addition, bypass raises significant questions of anticompetitive behavior by pipelines.

State and local regulatory bodies that currently have the authority to regulate the other aspects of the retail natural gas business are much better situated to weigh all of the relevant factors to determine whether bypass of a particular distributor is in the public interest. Moreover, the Natural Gas Act established a regulatory scheme which contemplates active regulation at the state level of retail service to end users.

STATEMENT OF
JEFF ENGLISH,
CITY MANAGER AND NATURAL GAS OPERATIONS MANAGER,
CITY OF WRENS, GEORGIA,
ON BEHALF OF THE
AMERICAN PUBLIC GAS ASSOCIATION
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
UNITED STATES SENATE
ON S. 2313 AND S. 1998

September 29, 1988

The American Public Gas Association ("APGA") supports legislation to restrain the Federal Energy Regulatory Commission ("FERC" or "Commission") from allowing -- in fact, encouraging -- the widespread physical bypass of local distribution company ("LDC") facilities by interstate pipelines and large industrial end users located within an LDC's service area. Decisions regarding the propriety of particular proposed bypasses are properly made at the local, retail level on a case-by-case basis by the state or local regulatory body which otherwise regulates the LDC's activities. Senator Alan Cranston (D-CA) has introduced S. 2313, legislation which would achieve these goals. Although APGA prefers the approach of S. 2313, APGA also supports S. 1998, introduced by Senator John Breaux (D-LA).

I.

APGA'S INTEREST AND POSITION

APGA is the national trade association of publicly-owned natural gas distribution systems, comprised of more than 230 members located in 33 states. It participates on behalf of its members in proceedings before the Federal Energy Regulatory Commission and the courts, and in legislative matters that involve important policy and/or legal issues affecting the natural gas industry.

The members of APGA are generally smaller gas distributors that obtain their gas supplies from only one interstate natural gas pipeline-supplier. Due to their respective sizes and financial resources, there is often great inequality of bargaining power and competitive clout between publicly-owned gas distributors and other natural gas industry participants. Generally, publicly-owned distributors are too small to invest heavily in storage and peak shaving facilities. Publicly-owned distributors have little operational flexibility and therefore must depend in large part on the FERC's regulatory oversight of natural gas rates and services mandated by the Natural Gas Act ("NGA")[1] to assure that they are not subjected to abuses of pipeline monopoly power and are able to participate in an increasingly volatile natural gas market.

Unfortunately, the FERC has all but abandoned its statutory responsibilities under the NGA and the Natural Gas Policy Act of 1978 ("NGPA").[2] Instead, over the last several years, the Commission has embarked upon a program, under the rubric of promoting competition, which encourages interstate pipelines to provide sales and/or transportation service directly to large industrial end users, thereby bypassing the LDCs that have traditionally provided gas service to those industrial users. Thus, despite the fact that interstate pipelines control the access to the gas supplies of both the LDCs and their customers, the FERC nevertheless is encouraging interstate pipelines to exercise their market dominance to "cream skim" the LDCs' largest, most attractive customers, i.e., the high load factor, industrial end users, leaving the captive residential, commercial, and small industrial customers with the burden of paying the entire costs of operating and maintaining the LDCs' systems, including the facilities built to serve the bypassing end users. Moreover, by its actions, the FERC has reached well beyond its jurisdictional parameters in an attempt to interpose its own version of competition at the retail level, even though retail sales and distribution of natural gas historically have been deemed by Congress and the Commission itself to be the province of state and local control and regulation.

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[1] 15 U.S.C. §§ 717, et seq.

[2] 15 U.S.C. §§ 3301, et seq.

For these reasons, APGA strongly supports the enactment of S. 2313, which would return to the appropriate state or local regulatory bodies the authority to determine whether bypass, under case-specific circumstances, is in the public interest after examining its impact upon all of the LDC's customers, and not just upon the prospective bypasser. However, since APGA believes that it is imperative that some legislation effectively addressing the bypass issue be enacted as soon as possible and hopefully during this session of Congress, APGA also supports the passage of S. 1998, which would allow state or local regulatory commissions, municipalities, and LDCs to petition the FERC for orders prohibiting bypass by interstate pipelines, which the Commission must issue if the LDC in question is willing to provide transportation without undue discrimination at cost-based rates as determined by its state or local commission.

APGA is impressed with the wide range of support that these bills have garnered from LDCs -- whether large or small, publicly- or privately-owned, and regardless of geographic location -- from state regulatory commissions, and from consumer groups. Included among the supporters of a legislative solution to LDC bypass are the small gas distributors belonging to APGA; large distributors, such as the members of the Associated Gas Distributors, Southern California Gas Company (the nation's largest gas distributor), and the Michigan Consolidated Gas Company; the National Association of Regulatory Utility Commissioners; the Citizen/Labor Energy Coalition; and the Consumer Federation of America. This broad support underscores the urgency for swift Congressional action to protect residential and other captive ratepayers from the adverse effects of LDC bypass. The key points presented by APGA's statement are as follows. (1) Physical bypass of an LDC's facilities by a large end user increases the captive residential, commercial, and industrial customers' share of the costs of operating and maintaining LDC facilities and threatens the viability of the LDC itself. (2) By authorizing such distributor bypasses, the FERC is permitting interstate pipelines to displace gas distributor service to large customers, i.e., to "cream-skim," thereby raising anticompetitive concerns. (3) State and local regulatory authorities are in a far better position than the FERC to weigh competing interests among LDCs, large industrial end users, and other customers to determine whether bypass of a particular distributor's facilities is in the public interest. (4) The regulatory scheme established by the NGA contemplates regulation of bypass by state and local authorities as part of their statutory authority to regulate gas at the retail level, not through federal regulation by the FERC.

II.

BYPASS OF LDCS HAS NEGATIVE COST AND SERVICE IMPACTS ON THE LDCS AND THEIR CAPTIVE CUSTOMERS

A national policy of permitting bypass of LDCs' facilities would have a detrimental impact on the distributors and the remaining captive residential, commercial, and industrial ratepayers. Such a policy would permit natural gas pipelines to engage in market raiding, whereby pipelines could offer gas service to large, high load factor customers at a lower price than the distributor is able to offer. Such "cream-skimming" would increase gas rates to those remaining retail gas consumers that have no alternative but to obtain service from the LDC and particularly could place small distributors in financial jeopardy.

Each customer of an LDC has the responsibility to pay its respective share of the fixed costs of constructing and operating the distributor's facilities. Indeed, each distributor constructs and operates its facilities in anticipation of serving a certain volume of gas consumption by both large and small users.

Allowing any large, high load factor end user located in an LDC's service territory to bypass physically its distributor's system has at least two obvious negative cost impacts. First, it forces the distributor's remaining customers, most of whom have no alternative but to obtain service from their LDC, to pay the share of the distributor's capital and operating costs attributable to the service to the large customer that leaves the system. In essence, the remaining customers would subsidize the additional capacity that the distributor was required to build to serve the larger, but now departed, customer.

Second, bypass of an LDC's facilities could result in the underutilization of those facilities. Since each distributor's system is initially designed to meet the distributor's anticipated demand, including that of the large customers, the system, after a larger customer has bypassed the LDC, becomes essentially over-built and inefficient from the perspective of the remaining customers. The remaining customers are left to pay higher rates to absorb the costs of the essentially over-built system.

A national policy encouraging bypass also discriminates among consumers on the basis of location. Large end users that fortuitously are located in close proximity to interstate pipelines would be far more able to bypass their LDCs than other end users on an LDC's system.

The harmful impact of bypass is particularly amplified when the LDC being bypassed is a small, municipally-owned gas distribution system. Many municipally-owned LDCs serve one or two large industrial customers which often constitute a large percentage of the system's total load. If an industrial customer of that size were to leave one of those small systems, the rate impact on the remaining captive customers would be devastating. Some of the costs attributable to the departing industrial customer that the remaining customers may have to pay are (i) the costs of operating and maintaining the distribution system, (ii) interstate pipeline demand charges based upon a service agreement which includes gas supply and capacity for the now departed industrial customer, (iii) pipeline take-or-pay costs, especially take-or-pay costs allocated by the pipeline based upon the distributor's failure to purchase gas from the pipeline at historical levels (known in FERC parlance as a "purchase deficiency" based allocation), and (iv) gas inventory charges based upon the distributor's failure to take a certain nominated level of gas from the pipeline.

In the face of these costs, the lost revenue stream from a departed industrial customer which formerly constituted a substantial percentage of the LDC's deliveries could place in question the financial viability of the municipally-owned distributor. Many municipal LDCs financed the construction of their systems through revenue bonds, repayment of which is contingent on generating a revenue stream from their major industrial customers. If a high load factor industrial customer departs the system, the municipal distributor may not be able to generate sufficient revenues to repay its financial obligations.

Unlike the FERC's hypothetical, economic-theory approach to decisionmaking, the concerns raised here by APGA are real. By way of an example, I can illustrate the predicament in which Wrens would find itself if its system were bypassed by one its major industrial customers.

The Wrens Gas System currently serves 1,200 customers and operates on an annual budget of approximately $4.2 million. The two largest gas consumers on the system are industrial customers that purchase approximately 88 percent of the natural gas sold at retail on the system.

One of the system's industrial customers is a particularly attractive target for bypass by an interstate pipeline. This customer purchases more than 60 percent of the gas which Wrens sells, and it is a high load factor customer, purchasing gas at constant levels throughout the year. The industrial plant is located closer to Wrens' interstate pipeline supplier's transmission facilities than to Wrens' distribution facilities. If this customer were to bypass Wrens' distribution system to be served directly by the interstate pipeline, that bypass would have a devastating financial impact upon the Wrens' system. Wrens simply would not be able to pay the fixed costs of operating the system and could not provide any revenue for the benefit of the City. In addition, because bypass by that industrial customer would result in a 60 to 70 percent reduction in Wrens' gas purchases, Wrens' gas costs will increase. To cover the revenue shortfall, Wrens would have to charge rates that are five or six times higher than current rate levels. A rate increase of that magnitude to Wrens' remaining customers is simply an unrealistic alternative.

In short, from a cost standpoint, bypass of an LDC's facilities will provide some at least short-term benefit to a large industrial end user. However, that benefit is being accorded to the industrial end user only through the shifting of considerable costs to the

LDC's other customers, and perhaps by jeopardizing the continued viability of the LDC itself.

III.

LDC BYPASS WILL ONLY EXACERBATE THE PROBLEM OF ANTICOMPETITIVE BEHAVIOR BY PIPELINES AND PRODUCERS

As the justification for their championing of a nationwide policy of liberal bypass, the FERC and the other bypass supporters have attempted to paint LDCs as bloated monopolies which fear competition. The fact is, of course, that LDCs are monopolies because of the economic efficiency which results from one entity providing retail gas service to thousands of individual consumers. This efficiency takes a number of forms, including, for example, non-duplication of facilities, increased load factor and total load size, and the provision of services such as peak shaving, which most consumers simply could not acquire on their own. In return for their monopoly status, LDCs, among other things, must provide gas service to all those so requesting, and as a result, must carry uncollectible accounts and must stand ready to serve the wayward, bypassing industrial end user, if and when that end user decides once again to demand service from the LDC.

The real anticompetitive problem does not result from the LDC's monopoly on gas distribution service, but from market bifurcation by pipelines and producers, in which large industrial end users with alternate fuel capability are charged lower market-clearing prices by producers and discounted transportation rates by pipelines, while LDCs, serving inelastic residential and commercial consumers, continue to be charged excessive producer gas costs and maximum pipeline sales and transportation rates. This anticompetitive monopoly price discrimination can place an LDC in a "price squeeze" situation, where the pipeline is able to obtain the LDC's large customers because, as a result of the pipeline's high wholesale sales and transportation prices to the LDC, the LDC is unable to compete at retail for this customer's business. Ironically, these various anticompetitive actions by pipelines and producers are all direct results of FERC policies instituted under the guise of fostering greater competition in the natural gas industry.

IV.

STATE AND LOCAL REGULATORS SHOULD DECIDE WHETHER A PARTICULAR BYPASS IS APPROPRIATE

The FERC has pursued an inflexible policy which assumes that bypass by interstate pipelines, in conjunction with the issuance of an "optional expedited certificate" under Order No. 436, is in the public interest.[3] That view, however, ignores the fact that the demographics of each LDC's customers and service territory or the particular services which the distributor provides may or may not favor distributor bypass. The FERC has neither the resources nor the knowledge necessary to analyze thoroughly all of the unique circumstances of each distributor's service territory to determine whether a proposed bypass is in the public interest. On the other hand, the state and local regulatory body that currently has the authority to regulate all other aspects of the retail natural gas business of a particular LDC is capable of weighing all of the relevant factors to determine whether bypass of that distributor is appropriate.

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[3] Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol: Final Rule and Statement of Policy, Docket No. RM85-1-000, FERC Stats. and Regs. (Regulations Preambles 1982-1985) ¶ 30,665, pp. 31,571-72 (1985), modified, Order No. 436-A, FERC Stats. and Regs. (Regulations Preambles 1982-1985) ¶ 30,675, modified further, Order No. 436-B, III FERC Stats. & Regs. ¶ 30,688, reh'g denied, Order No. 436-C, 34 FERC ¶ 61,404, reh'g denied, Order No. 436-D, 34 FERC ¶ 61,405, reconsideration denied, Order No. 436-E, 34 FERC ¶ 61,403 (1986), vacated and remanded sub nom., Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987), cert denied, 108 S.Ct. 1468 (1988), on remand, Order No. 500, Interim Rule and Statement of Policy, Docket No. RM87-34-000, III FERC Stats. & Regs. ¶ 30,761 (1987); extension of time granted, Order No. 500-A, III FERC Stats. & Regs ¶ 30,770, reh'g denied, Order No. 500-B, III FERC Stats. & Regs. ¶ 30,772 (1987), modified, Order No. 500-C, (continued...)

State and local regulatory bodies have inherent advantages over the FERC in scrutinizing the LDCs operating within their respective jurisdictions. State and local regulatory bodies are familiar with the economic conditions in the state or locality in which the gas distributor is located. Moreover, the state and local regulatory authorities are familiar with the financial stability of the LDCs operating within their respective jurisdictions. Thus, the state and local regulatory bodies can determine whether a specific LDC could withstand the potential financial burdens associated with a particular bypass, and that regulatory body could then determine more accurately the extent of the rate impact of a bypass on the remaining customers.

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[8] (...continued)
III FERC Stats. & Regs. ¶ 30,786, modified, Order No. 500-D, III FERC Stats. & Regs. ¶ 30,800, Order No. 500-E, 43 FERC ¶ 61,234 (1988).

It should be emphasized that regulation of bypass at the state and local level does not preclude the industrial end user from intervening in proceedings before state and local regulatory bodies to demonstrate its need to effect a bypass of its LDC's facilities. There is no basis for assuming that state and local regulatory authorities will not be sensitive to the needs of industrial end users, particularly where the viability of the industrial concern may be in question.

It is clear that regulation of bypass would be more effective at the state and local level, where state and local officials are familiar with the unique circumstances of each distributor's service territory. Moreover, permitting state and local regulatory commissions to perform their traditional role of retail regulation of natural gas is consistent with principles of federalism which the Reagan Administration has espoused for the past seven plus years. Inexplicably, while the rest of the Administration has aggressively sought to cut back preexisting federal regulation and to grant authority instead to the state and local governments, the FERC has on this issue marched to a different tune, doing all that it can to wrest away from state and local regulators their authority to regulate retail natural gas service where a physical bypass is proposed. Enactment of legislation that would re-establish state and local regulatory authority over retail natural gas service and would leave to state and local regulators the decision concerning whether bypass is in the public interest is imperative.

V.

STATE AND LOCAL REGULATION ~~OF BYPASS~~ IS CONSISTENT WITH THE STATUTORY SCHEME WHICH CONGRESS ESTABLISHED IN THE NGA

With the enactment of the NGA, Congress established a multi-layered scheme which generally contemplated active regulation of natural gas at the wholesale level by the FERC's predecessor, the Federal Power Commission ("FPC"), and regulation at the retail level by the states. Section 1(b) of the NGA delineates the jurisdictional authority of the FERC:

> The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.[4/]

Until recently, the FERC and the FPC had maintained a long-established policy favoring service to industrial end users by LDCs.[5/] That policy was firmly grounded within the statutory scheme contemplated by Congress in the NGA. However, in recent

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[4/] 15 U.S.C. § 717(b).

[5/] See, e.g., Missouri Edison Co., 47 FPC 849 (1972); Panhandle Eastern Pipe Line Co., 36 FPC 1107, 1109 (1966), modified on other grounds, 37 FPC 314 (1967), aff'd sub. nom., Panhandle Eastern Pipe Line Co. v. FPC, 386 F.2d 607 (3d Cir. 1967); Southern Natural Gas Co., 25 FPC 925 (1961); American Louisiana Pipeline Company, 20 FPC 575 (1958).

rulemaking proceedings, adjudicative proceedings, and in public pronouncements, the FERC has cast aside this policy, has reached beyond its jurisdictional parameters, and has attempted to override the concerns of state and local regulatory authorities by establishing itself as the sole arbiter of determining whether interstate pipelines may bypass local gas distributors.

For example, in Panhandle Eastern Pipe Line Company, Opinion No. 275-A,[6/] the FERC issued a certificate authorizing Panhandle Eastern Pipe Line Company ("Panhandle") to provide interruptible transportation service to an industrial end user, National Steel Corporation, which included a bypass of the LDC, Michigan Consolidated Gas Company ("MichCon"). The FERC dismissed MichCon's arguments and those of the Michigan Public Service Commission concerning the potential detrimental effect that bypass would have on MichCon and its customers. The Commission cited its decision in American Distribution Company (Alabama Division),[7/] stating:

> In a competitive market environment, the parties are at a risk for their own decisions, and the need to provide competitive services is the factor that leads to improved service at lower cost for consumers. * * * Under these circumstances, and in the absence of any suggestion of unfair competition, we believe

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[6/] Opinion No. 275-A, 40 FERC ¶ 61,220 (1987), aff'd, Opinion No. 275-B, 42 FERC ¶ 61,076, reh'g request dismissed, 42 FERC ¶ 61,381 (1988), appeals pending sub nom., Michigan Consolidated Gas Co. v. FERC, D.C. Cir. Nos. 88-1062, et al.

[7/] 37 FERC ¶ 61,282 (1986).

> that the public interest is best served by our sustaining the result of that competition.[[8]]

It is clear from the FERC's holding in Opinion No. 275-A that the Commission took it upon itself to determine whether bypass was in the public interest. The Commission essentially concluded that MichCon was unable to provide gas service to National Steel at as cheap a price as Panhandle; therefore, bypass of MichCon's facilities was supposedly appropriate. Notably absent from consideration in the FERC's decision, however, was any substantive discussion of the potential impact that the bypass would have on MichCon and its other ratepayers, with the FERC dismissing arguments concerning that impact as "speculative."[9] This total disregard for the potential impact of bypass on captive residential and commercial consumers reflects the fact that the FERC is ill-suited to respond to extremely important state and local concerns. Moreover, permitting the FERC to become involved in performing a detailed analysis of the impact of a bypass on local consumers is clearly beyond the scope of the FERC's jurisdiction.

The FERC's lack of concern toward the potential adverse impact of bypass on LDCs and their customers has been particularly egregious in its interpretation of Section

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[8] 40 FERC at p. 61,751. (quoting American Distribution Company (Alabama Division), 37 FERC at pp. 61,854-55). In a separate United States District Court proceeding involving the FERC's jurisdiction over the MichCon bypass, the court held that the State of Michigan's regulatory power over National Steel's direct purchase of gas from a producer in Oklahoma was preempted by the NGA. See National Steel Corp. v. Long, Nos. L87-30 CA5, et al. (W.D. Mich. June 16, 1988).

[9] 40 FERC at p. 61,751.

311(a) of the NGPA[10] in a series of orders issued in July in Texas Eastern Transmission Corporation, Docket Nos. RP88-81, et al.,[11] Algonquin Gas Transmission Company, Docket Nos. RP87-73-000, et al.,[12] Hadson Gas Systems, Inc., Docket No. GP88-11-000 ("Hadson"),[13] Cascade Natural Gas Corp. v. Northwest Pipeline Corp., et al., Docket No. CP88-286-000 ("Cascade").[14] In the Hadson order in particular, the FERC interpreted Section 311 of the NGPA so broadly that it would authorize bypass of an LDC's facilities without providing notice and the opportunity to be heard and without any consideration of the potential detrimental impacts of bypass on LDCs and their customers..

Section 311(a) provides, in relevant part: ". . . [t]he Commission may, by rule or order, authorize any interstate pipeline to transport natural gas on behalf of -- (i) any intrastate pipeline; and (ii) any local distribution company." This provision authorizes the Commission to institute a new class of interstate transportation service which may be provided without approval under Section 7 of the NGA.[15]

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[10] 15 U.S.C. § 3371(a).

[11] 44 FERC ¶ 61,080 (1988).

[12] 44 FERC ¶ 61,078 (1988).

[13] 44 FERC ¶ 61,082 (1988).

[14] 44 FERC ¶ 61,081 (1988).

[15] See 15 U.S.C. § 717f.

In Hadson, the Commission issued a declaratory order construing the statutory requirement that transportation by interstate pipelines under Section 311(a) must be "on behalf of" LDCs or intrastate pipelines. The FERC found that the "on behalf of" requirement can be satisfied by an agency agreement between a broker or marketer and any LDC or intrastate pipeline in which the "on behalf of" LDC or intrastate pipeline receives some economic benefit.[16] The Commission failed to delineate the nature of an appropriate agency agreement under Section 311, nor did it discuss the threshold level of economic benefit which the LDC or intrastate pipeline must receive to satisfy Section 311. Since almost any transportation transaction may fit within the broad parameters of this interpretation, provided that an LDC or intrastate pipeline located anywhere in the United States signs an agency agreement through which it receives "some economic benefit," the FERC's decision in Hadson appears to authorize virtually any transportation transaction to occur without regulatory scrutiny under Section 7 of the NGA. In addition, the FERC's decision ignores any legitimate role for state or local regulatory authorities to scrutinize the transaction.

This broad interpretation would allow bypass to occur without the provision of notice and the opportunity to be heard for the adversely affected entities and without any consideration of local factors. Indeed, in the Cascade order, the FERC acquiesced in a bypass in exactly this manner. In Cascade, the FERC dismissed, without hearing, a complaint lodged by an LDC, Cascade Natural Gas Corporation ("Cascade"), that was being bypassed by one of its industrial customers, Chevron Chemical Company ("Chevron"), pursuant to a Section 311 transaction. The gas was being transported directly to Chevron by Northwest Pipeline Corporation ("Northwest"), Cascade's principal pipeline-supplier. The LDC on whose behalf the gas was supposedly being transported (for Section 311 purposes) was not located near Cascade and appeared to have no interest in the transaction other than the use of its name. The FERC refused to hear the complaint, stating only that "[t]o the extent that Northwest continues transportation to Chevron pursuant to section 311, it must comply with the requirements outlined in Hadson."[17] In summarily dismissing the complaint, the FERC ignored any consideration of Cascade's demography, financial concerns, competitive services which Cascade either already provides or may provide to Chevron, or any other circumstances unique to Cascade or it customers which would be affected by the bypass. Putting aside questions concerning whether the FERC has the jurisdiction to authorize bypass in the first instance, such a broad interpretation of Section 311 constitutes a de facto repeal of Section 7 of the NGA. Congress clearly did not intend that Section 311 be given such a broad interpretation.

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[16] See 44 FERC at pp. 61,250, 61,253.

Indeed, the FERC in recent years appears to be more interested in attempting to regulate transactions at the burner tip in the state of consumption, over which it does not have jurisdiction, than the activities of interstate pipelines over which it does have the duty to regulate to protect consumers from exploitation at the hands of these pipelines. The comments of FERC Chairman Martha O. Hesse, as reported in the May 9, 1988 edition of Inside F.E.R.C., also illustrate the desire of at least one FERC commissioner to impose the FERC's theory of competition on LDCs and state and local regulatory bodies:

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[17] 44 FERC at p. 61,246.

> A more receptive attitude by Ferc toward bypass is not an option for getting distributors to go open access, Hesse said. She told reporters that she will maintain her long-held position on bypass -- if the distributor is willing to meet the competitive terms of a proposal, the bypass is uneconomic and unacceptable; if it is not willing, then the bypass is acceptable. Hesse was critical of any non-competitive distributor seeking to shift costs to remaining customers following a bypass, saying "it seems to me that stockholders are responsible . . . for the actions of management." But that is an issue for state regulators to deal with, she added.[[18]]

The Chairman's remarks reflect a narrow, myopic view of the impact of bypass which considers only the LDC's ability to compete with the spot market price or the pipeline's direct sale price, and which completely ignores the potentially devastating adverse impact that bypass may have on the distributor's remaining ratepayers[19] and ignores the possibility that the pipeline may be using its competitive control over the distributor's access to gas supplies to effect a "price squeeze" to skim-off the LDC's largest customers.

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[18] "Hesse Turns Up Heat To Get LDCs To Become Open-Access Transporters," Inside F.E.R.C., May 9, 1988, page 2.

[19] Not to mention that Chairman Hesse ignores the fact that for a municipal LDC, there are no "stockholders" to saddle arbitrarily with the cost of facilities constructed to serve the bypassing end user.

VI.

CONCLUSION

A national policy favoring LDC bypass, dictated by the FERC, is inconsistent with the delicate and deliberate scheme of dual regulation at the federal and state levels contemplated by the NGA, and would not protect captive residential and small commercial consumers. Further, regulation of LDC bypass at the federal level is not in the public interest because state and local regulatory bodies are in the best position to weigh all of the relevant factors to determine whether bypass under particular circumstances is in the public interest. For these reasons, APGA urges Congress expeditiously to enact S. 2313 or, in the alternative, S. 1998, to return the authority to regulate LDC bypass to the state and local level.

Thank you for providing APGA with the opportunity to submit this statement on most important subject.

AGD

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September 29, 1988

Howard M. Metzenbaum, Chairman
Energy Regulation and Conservation
  Subcommittee of the Senate Energy
  and Natural Resources Committee
Hart Senate Office Building
Room 212
2nd and C Streets, N.E.
Washington, D.C. 20510

Dear Senator Metzenbaum:

The Associated Gas Distributors (AGD), an informal association of East Coast local natural gas distribution companies (LDCs), respectfully submits this letter along with an attached Statement and requests that they be included in the record of the hearing to be held September 29, 1988 before the Energy Regulation and Conservation Subcommittee on S. 2313 and S. 1998. The attached Statement was previously submitted for inclusion in the record compiled for hearings held May 25, 1988 before the Energy and Power Subcommittee of the House Energy and Commerce Committee on H.R. 4089, the companion bill to S. 2313. H.R. 4089 and S. 2313 are identical in all respects and the remarks submitted by AGD are, thus, equally relevant to your Subcommittee's consideration of this very important issue for natural gas consumers nationwide. As with H.R. 4089, AGD strongly supports S. 2313 and urges its passage without delay.

The two pending legislative initiatives which are the subject of your Subcommittee's hearing -- S. 2313 and S. 1998 -- address the serious and growing problem of "LDC bypass." This phenomenon occurs when an interstate natural gas pipeline company invades the local gas utility's service area and provides direct service to the utility's large industrial customers. As AGD's Statement illustrates, recent federal regulatory changes have enabled LDC bypass to occur virtually free of federal regulation. More disturbing is the position taken by the Federal Energy Regulatory Commission (FERC), the agency purportedly responsible for reviewing pipeline bypass proposals at the federal level, that the state and local authorities traditionally responsible for regulating bypass at the local level are without jurisdiction to regulate certain forms of bypass.

AGD's May 25, 1988 Statement in support of H.R. 4089/ S. 2313 remains timely with respect to the LDC bypass issue. Moreover, two important events have occurred since May which make passage of this legislation all the more critical.

First, on June 16, 1988, a United States District Court for the Western District of Michigan issued an opinion in an LDC bypass case which squarely deprives state and local regulatory authorities of jurisdiction over certain LDC bypass arrangements. In National Steel Corp. and Panhandle Pipe Line Co. v. William E. Long, et al., Case Nos. L87-30 CA5, et al., the issue before the court was whether the regulatory authority of the Michigan Public Service Commission was preempted by a decision of the FERC to permit Panhandle, an interstate pipeline, to bypass MichCon, the local distributor, and provide a direct, transportation-only service to National Steel, one of MichCon's largest industrial end user customers.

In National Steel, the court acknowledged that the state would have unquestionable authority if Panhandle were providing a sales service directly to National Steel; it also recognized the "substantial local interests at stake" in such a bypass case. The court determined, however, that Michigan's interests are preempted by those of the federal regulatory authority where a transportation bypass arrangement is involved, i.e., where the end user buys gas not from the pipeline but from some other source, and the pipeline merely transports the gas directly to it. In conclusion, the court explicitly noted that if this area of federal preemption offers inadequate protection of the important local interests at stake in a bypass case, "then it is for Congress to fashion an appropriate remedy." Slip op. at 22.

The second important development affecting the LDC bypass issue is a series of orders issued by FERC regarding the availability of interstate pipeline transportation service that is not subject to any public interest regulatory review. Under Section 311(a) of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3371(a) (1982) (NGPA), FERC is authorized to permit interstate pipeline transportation service "on behalf of" LDCs and intrastate pipelines free of FERC's NGA jurisdiction. FERC has done so through its promulgation of implementing regulations, and pipelines may now offer § 311 transportation on a virtually unregulated basis, so long as they abide by the Commission's generic rate and nondiscriminatory service conditions.

In its recent orders, FERC has interpreted the statutory requirement that § 311 transportation be "on behalf of" LDCs and intrastate pipelines in such a manner as to open this non-NGA jurisdictional transportation to virtually all shippers, including parties bypassing local utilities. Specifically, in Hadson Gas Services, Inc., Docket No. GP88-11-000 (July 19, 1988), FERC announced that for a transportation request to qualify for § 311 transportation, the only involvement an LDC or intrastate pipeline need have with the arrangement is the receipt of some unspecified "economic benefit". The absurdity of this test was exemplified in a companion case in which an interstate pipeline had bypassed a Washington State LDC to serve one of its industrial end user customers on the pretext that such service was "on behalf of" an LDC located in Idaho that was receiving a nominal per-dekatherm charge for the use of its name. Cascade Natural Gas Corporation v. Northwest Pipeline Corp., Docket No. CP88-286-000 (July 19, 1988).

There are no protest or public interest review procedures in place for NGPA § 311 transportation; therefore, such transportation escapes any significant federal regulatory scrutiny. When combined with FERC's laissez faire attitude on bypass and the National Steel court's preemption of state and local jurisdiction over transportation bypasses, the results are completely unfettered bypass opportunities. This situation is rife with potential to harm the public interest. It requires immediate action by Congress to prevent further, irremediable harm to natural gas consumers nationwide.

Upon consideration of this important issue, AGD respectfully urges the Energy Regulation and Conservation Subcommittee to act favorably on S. 2313.

Respectfully submitted,

Dana Contratto

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Counsel for Associated Gas
Distributors

AGD

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HOUSE SUBCOMMITTEE ON ENERGY AND POWER
HEARING ON H.R. 3445 AND 4089

Statement of
Associated Gas Distributors
Executive Summary

Associated Gas Distributors (AGD), an informal association of thirty-nine East Coast local natural gas distribution companies (LDCs) applauds the Subcommittee for investigating the problem of federal regulatory policies that allow, even encourage, the unfettered and indiscriminate bypass of local gas utilities by interstate pipeline companies for direct service to the LDCs' major industrial customers.

LDC bypass has become a significant and growing problem in recent years due to certain regulatory and deregulatory initiatives undertaken by the Federal Energy Regulatory Commission (FERC or Commission). Since its promulgation of Order No. 436, FERC has reversed its long-held policy of discouraging the bypass of local utilities by interstate pipelines. The Commission traditionally held that cost shifting implications for the LDC's remaining customers, as well as notions of proper load balance, protection of pipeline capacity for LDC load, and a preference for greater local regulation outweighed the interests of the bypassing pipeline and industrial end user. FERC is now aggressively promoting free market competition and focusing on the short-term, customer-specific economic benefits that may be achieved through a bypass. The federal emphasis on competition, however, has failed to acknowledge the many public utility and other cost burdens on an LDC that impair its ability to compete against a pipeline for service to large industrial customers.

FERC has drastically reduced its regulation over proposals for new pipeline services, through "budget" and blanket certificate programs and an expansive implementation of pipeline self-implementing transportation services. While relaxing its own regulatory role in the context of bypass, moreover, FERC has proclaimed that the new, "transportation-only" form of bypass being undertaken most frequently today is beyond the jurisdictional authority of the States to regulate in any event.

The impact of a bypass on the remaining ratepayers on the LDC's system can be devastating. In direct cost terms, these customers must absorb a greater share of the utility's cost of service. Indirectly, they suffer the increased gas costs resulting from the LDC's loss of supply and load balancing flexibility. Bypass creates, moreover, a spiral of rising costs that encourages additional industrial load to bypass the LDC's system. The result, ultimately, is an uneconomically segregated market in which only high priority, seasonal customers are left to be served by the LDC.

AGD strongly endorses H.R. 4089 as the most fair, reasonable approach to the problem of LDC bypass. This legislation does not prohibit all bypass, but rather puts the decision of whether a bypass would serve the public interest where it properly belongs: with the state or local regulatory authorities. The local regulators are in the best position to evaluate fairly the competing interests involved where a bypass is proposed; they have the power to alter LDCs' rate design or to force LDCs to offer more competitive services to their industrial customers, if such would be in the public interest. H.R. 4089, moreover, explicitly exposes LDCs to competition in that it forces the LDC to offer state-authorized transportation services, in order to protect itself against a bypass. Thus, the LDCs' industrial customers will have access to alternative gas supply sources.

May 25, 1988

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STATEMENT

OF

ASSOCIATED GAS DISTRIBUTORS

before the

HOUSE SUBCOMMITTEE ON

ENERGY AND POWER

HEARING ON H.R. 3445 AND 4089

May 25, 1988

STATEMENT OF
ASSOCIATED GAS DISTRIBUTORS

Associated Gas Distributors (AGD) is an association of thirty-nine local natural gas distribution companies which provide gas utility service in the major markets of the East Coast from Maine through Georgia. Together, the AGD companies' annual sales and transportation services constitute approximately 25 percent of the natural gas moved in the Nation's interstate natural gas supply network. Each AGD member company is a public utility, whose rates and services are regulated by state or local authorities.

AGD appreciates the opportunity to submit for the record its member companies' views on a very important issue confronting the gas consuming public today, namely, the ease with which interstate pipelines have become able to bypass local gas distribution companies or "LDCs" to provide direct service to the utilities' large industrial customers. In an attempt to shed some light on this nationwide problem, and to provide a context for the Subcommittee's consideration of the issues raised, these comments will address the following questions: (1) why has LDC bypass become such a serious problem; (2) why should Congress be concerned about it; in other words, just how significant is the problem of bypass; and (3) what is the fairest and most appropriate means to resolve the competing interests that are at stake when an LDC bypass is proposed.

I. LDC BYPASS AND THE FERC REGULATORY CLIMATE

The first question these comments address is why has bypass suddenly become a major problem in the natural gas industry? The answer, which requires some exploration of the historical and regulatory context, lies in recent regulatory and deregulatory initiatives undertaken by the Federal Energy Regulatory Commission (FERC or Commission). At bottom, FERC has decided to withdraw from its historical role as guardian of all natural gas consumers, while at the same time it is asserting that the States may not fulfill their traditional consumer protection duties where bypass is concerned, either.

A. FERC Reversal Of Its Own Bypass Policy

Traditionally, FERC's general policy with respect to the bypass of LDC industrial customers was clear. Although not absolute, FERC and its predecessor, the Federal Power Commission (referred to here interchangeably with FERC as "Commission", or FPC), strongly favored the provision of local, i.e., retail, service by local public utilities, and therefore disfavored LDC bypass. See, e.g., Missouri Edison Co. v. FPC, 479 F.2d 1185 (D.C. Cir. 1973); Panhandle Eastern Pipe Line Company, 36 FPC 1107 (1966). The Commission articulated some of the concerns which underlay its general policy as follows:

> In principle, lines of interstate transmission companies should not be laid down on top of local distribution lines for the service of profitable industrial loads that can be served by the local distributor. On the contrary, such load, absent

> unusual circumstances not now foreseen, should be served by the distribution company, to the benefit of the local consumers in respect of (a) its increased revenues and profits taken into account by State Commissions in fixing rates and (b) its improved load factor, reducing its unit cost of service . . . . Interstate transmission companies exist primarily to serve local distributors, and load factor benefit to distributors directly benefits the suppliers.

Southern Natural Gas Company, 25 FPC 925, 937 (1961).

The most important consideration militating against bypass has clearly been the extent to which the loss of large industrial customers of the LDC shifts costs to its remaining customers. See, e.g., American Louisiana Pipe Line Co. et al., 20 FPC 575 (1958). Other factors cited by the Commission include (1) the fact that the LDCs, as the original customers of the pipelines, were "saddled . . . with most of the cost of construction and maintenance of the transportation facility," and therefore deserve a superior right to the pipeline's limited capacity over that of direct end user customers, Panhandle Eastern Pipe Line Co. v. FPC, 232 F.2d 467, 472 (3d Cir.), cert. denied, 352 U.S. 891 (1956), and (2) the likelihood that LDC service would be subject to greater regulatory supervision, which is "of prime importance and wholly in the public interest." Missouri Edison Co., 479 F.2d at 1188.

Ironically, the Commission even considered the competition principles it now so aggressively promotes -- and dismissed them as unpersuasive and outweighed by more important considerations in the context of LDC bypass. Specifically, in Natural Gas Pipeline Company of America, 34 FPC 771 (1955), the Commission was faced with choosing one of three competing certificate applications to provide increased natural gas service to the St. Louis, Missouri, metropolitan area. One proposal consisted of a new pipeline that would supply gas directly to 14 area industries, among others. That proposal was chosen by the hearing examiner, on the ground that it would introduce pipeline competition to a formerly LDC-monopolized geographic area. In rejecting the hearing examiner's decision, the Commission noted that

> Since these industrial loads constitute the major portion of the industrial load now served by Mississippi, not only will Oklahoma Illinois' presence in the St. Louis market not result in competition, it will disturb the market balance which now exists between industrial and residential customers. Proper load balance is an important consideration in a natural gas market which is of advantage to both the consumers and the industrials because it provides a supply of natural gas at a reasonable price which would not be otherwise available . . . . Even if there is an ultimate market for an additional large supply of gas in the St. Louis area the way to meet it is not by divorcing the industrial and residential loads.

Id. at 778. The Commission concluded that, while this type of competitive pressure might be an "indirect spur" to improve the quality of the present supplier's service, "it would be competition in a way not calculated to promote the public interest." Id. See also Transwestern Pipeline Company, 36 FPC 176, 200-01 (1966).

In sharp contrast, FERC's pronouncements in recent years indicate that not only has it abandoned its long-held policy against LDC bypass, its new policy actually promotes bypass as a form of desirable pipeline "competition" for the LDCs' traditional loads. FERC has drastically reduced its role as regulator of proposals for new pipeline services. Where once FERC made a case-specific determination of whether a new pipeline service or construction of facilities would serve the public convenience and necessity, it now grants one-time "blanket" authorizations for pipelines to transport gas,[1] make certain types of sales,[2] and even construct certain new facilities.[3] Where a new pipeline service would not qualify for "blanket" authorization, FERC has implemented an "optional, expedited certificate" procedure.[4] Under this process, a pipeline that supplies certain standard information and agrees to accept the economic risks of its new venture will be presumed to satisfy the public interest, and the Commission's normal hearing process as to bypass issues is thereby short-circuited.

Further, under Section 311 of the Natural Gas Policy Act (NGPA), 15 U.S.C. § 3371 (1982), transportation performed by an interstate pipeline on behalf of an intrastate pipeline or

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[1] See 18 C.F.R. Part 284 (1987).

[2] See 18 C.F.R. § 157.210.

[3] See 18 C.F.R. § 157.208.

[4] See 18 C.F.R. § 157, Subpart E.

LDC was removed from FERC Natural Gas Act (NGA) jurisdiction. The Commission has interpreted this provision also to exclude from its jurisdiction any facilities constructed and operated solely for NGPA Section 311 transportation. Although the statutory language would appear to exclude direct pipeline/end user transactions, in fact the "on behalf of" requirement has been construed extremely broadly, thus making a host of bypass arrangements potentially eligible for the NGA jurisdictional exclusion, so long as an intrastate pipeline or LDC is somehow involved with the transaction (no matter how remotely or tenuously).

Finally, even where the Commission has addressed the bypass issue in the context of a full-blown NGA Section 7 certificate hearing, its new policy is to focus on the short-term economic gains of the pipeline and industrial customer, and to dismiss the consequent impact upon the bypassed LDC's remaining ratepayers. For example, in American Distribution Company (Alabama Div.), 37 FERC ¶ 61,282 (Dec. 23, 1986), the Commission approved a bypass over the protests of both the LDC and its state utility commission, on the grounds that the bypassing pipeline had won in "fair competition," and that a hearing to examine the consequent rate impact on the LDC's customers would not be necessary. Again, in Panhandle Eastern Pipe Line Company, 40 FERC ¶ 61,220 (Sept. 10, 1987), the Commission approved a bypass on the ground that it saw "no reason to deviate from our belief that competition best serves the public interest . . . ." Id. at 61,752. Generally, in the series of orders promulgating the new, nondiscriminatory transportation and optional, expedited certificate programs, i.e., Order No. 436 and progeny, the Commission signaled the end of its traditional anti-bypass policy with repeated warnings to distributors that competition was the order of the day, and that LDC service would be considered on a competitive par with direct pipeline service. See, e.g., Order No. 436, FERC Stats. & Regs. (Regulations Preambles) ¶ 30,665 at 31,570-72 (Oct. 9, 1985), vacated and remanded on other grounds, Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987), cert. denied, 108 S. Ct. 1468 (1988). At the federal level, an outcome in favor of a proposed bypass is, thus, virtually guaranteed.

The unworkable nature of FERC's new "competition" policy in the context of LDC bypass is clear. Trusting that the public interest will best be served through open, free-market competition may be defensible where the competitors stand on an equal footing. Here, however, the traditional LDC provider of the service clearly is not an equal competitor with a large interstate pipeline. Most importantly, the LDC, unlike an interstate pipeline, is a public utility that is subject to extensive state or local regulation and numerous public interest responsibilities. For example, LDCs are required to carry customers who do not pay their bills, to offer conservation programs, and to perform other such community services. All of these responsibilities add to their costs of operation. Moreover, as utilities, LDCs are under a legal obligation to serve "the public" -- meaning all natural gas consumers, and not just lucrative large, industrial loads.

Second, in most bypass cases, the LDC itself is supplied with gas -- sometimes exclusively -- by the pipeline that seeks to perform the bypass. Here, the imbalance of market power between these two would-be "competitors" is stark. In the sales context, it is fantasy to believe that an LDC could undercut its own wholesale supplier without taking a substantial loss on the sale. So too in most cases where a purely transportation service is involved, unless the costs of constructing an interconnection between the pipeline and the end user are so high that bypass would be an unattractive option in any event.

Further, most States impose a gross receipts tax of as much as 14% (i.e., New Jersey) on the sale of natural gas within the State. The tax can he avoided by industrial end users if they purchase gas outside the State. The only way an LDC could compete successfully on a pure price basis would be to offer a gas price so far below the competition that even after the tax was imposed it would be the lowest price. Such a scenario is unrealistic in the extreme, and serves to exemplify the truly "uncompetitive" nature of the marketplace in which the LDC finds itself.

Finally, as this Subcommittee is undoubtedly aware, the entire natural gas industry is currently grappling with the most enormously costly and unyielding problem in its history -- the problem of high take-or-pay contracts for high-priced gas. To date, the Commission has indicated, in Order No. 500,[5] that pipelines will be able to pass through to their customers, primarily LDCS, up to 100% of their costs of settling out take-or-pay responsibilities, depending on which type of recovery mechanism the pipeline chooses. Thus, LDCs have already begun to receive substantial surcharges and increased gas costs from their pipeline suppliers that represent the flowthrough of huge take-or-pay costs. Of course, the pipelines are neither obligated nor, in most cases, willing or able to assess a share of these costs to a new sales or transportation industrial customer. Thus, LDCs' costs are being artifically inflated by take-or-pay costs, which makes them still less able to compete for their industrial markets. At the same time, industrial end users have an opportunity to escape *all* take-or-pay cost incurrence by simply bypassing their LDCs. This problem highlights not only the LDCs' uncompetitive posture vis a vis pipeline direct services, but also an additional set of added costs forced unfairly on the LDCs' remaining residential, commercial, and small industrial customers. Thus, an indirect result of bypass is that captive residential and other small gas consumers will bear the brunt of the take-or-pay burden.

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[5] *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III FERC ¶ 30,761 (Aug. 7, 1987), *appeals pending*, *American Gas Association v. FERC*, D.C. Cir. No. 87-1588.

B. FERC Preemption of State Bypass Review

In tandem with FERC's own traditional policy disfavoring bypass is a line of U.S. Supreme Court precedent that, until recently, assured state and local regulatory authorities of a role in the determination of whether a proposed LDC bypass was in the public interest or not. In Panhandle Eastern Pipe Line Co. v. Public Service Commission of Indiana, 332 U.S. 507 (1947), the Supreme Court determined that the States are empowered to regulate the rates and services of interstate pipeline direct sales to end users. In Panhandle Eastern Pipe Line Co. v. Michigan Public Service Commission, 341 U.S. 329 (1951), it found, further, that the States may require an interstate pipeline to obtain a certificate of public convenience and necessity at the state level, regardless of whether it holds a federal certificate, in order to perform a direct sale. In both cases, the Court emphasized the "essentially local" nature of the interests involved, despite the service being "clearly interstate commerce." Id. at 333. Specifically, in the Panhandle (Michigan) case, the Court stated:

> The facts in the instant case show that the proposed sales are primarily of local interest. They emphasize the need for local regulation and the wisdom of the principles [of permitting states to regulate matters "essentially local" in aspect without infringement of the Commerce Clause] just discussed. To accommodate its operations, appellant [interstate pipeline] proposes to use the streets and alleys of Detroit and environs. A local utility already operating in the same area, Consolidated, receives its entire supply of natural gas from appellant. A

> substantial portion of Consolidated's revenues is derived from sales to large industrial consumers. Appellant ignored requests of Consolidated for additional gas to meet the increased wants of its industrial customers. Instead of attempting to meet increased needs through Consolidated, appellant launched a program to secure for itself large industrial accounts from customers, some of whom are already being served by Consolidated. In connection with the Ford Motor Company, it is noteworthy that the tap line by which appellant proposed to serve Ford directly would be substantially parallel to and only a short distance from the existing tap line by which Consolidated now serves Ford.
>
> Thus, not only would there be two utilities using local facilities to accommodate their distribution systems, but they would be seeking to serve the same industrial consumers. Appellant asserts a right to compete for the cream of the volume business without regard to the local public convenience or necessity. Were appellant successful in this venture, it would no doubt be reflected adversely in Consolidated's over-all costs of service and its rates to customers whose only source of supply is Consolidated. This clearly presents a situation of "essentially local" concern and of vital interest to the State of Michigan.

Id. at 333-34. Moreover, the Court found, in both cases, that the State's actions had not been preempted by the Natural Gas Act, stating that this federal statute was "drawn with meticulous regard for the continued exercise of state power, not to handicap or dilute it in any way." Panhandle (Indiana), 332 U.S. at 517-18.

These two Supreme Court cases would seem to close the door on any argument that the state and local commissions responsible for regulating affected local utilities could be precluded from making their own public interest determination in a bypass case. However, the natural gas industry's recent -- and FERC-sponsored -- efforts to "unbundle" the sale and transportation of gas at both the interstate and local levels have allowed a new form of bypass to occur. Now an industrial end user may connect with an interstate pipeline to receive a transportation-only service from the pipeline, and purchase the gas to be transported from yet another, out-of-state supplier. Such an arrangement has the added benefit of avoiding the state gross receipts taxes described above. "Transportation bypass," then, does not involve the pipeline in a retail sale of gas, which is the critical distinguishing feature from the Panhandle precedent.

And what of the States' ability to regulate a transportation bypass case? Although this question has not yet been finally decided by a court, FERC has made plain its assessment that, as transportation in interstate commerce, this type of transaction would be exclusively subject to federal, i.e., FERC, jurisdiction. In other words, the same state and local authorities that are empowered to regulate a sales bypass would be preempted from any regulation over a transportation bypass.

This anomalous result is exemplified in two recent FERC bypass cases. In ANR Pipeline Company, 34 FERC ¶ 61,238 (Feb. 28, 1986), a state public service commission argued that FERC lacked jurisdiction over a pipeline's tie-in facilities to an industrial end user on the ground that such facilities were for the "local distribution" of gas. The Commission rejected this, stating that

> Inasmuch as the tie-in facilities would be an essential and integral element of the interstate transportation of gas by [the pipeline] to [the end user], they fall within the Commission's jurisdiction over the construction and operation of facilities used in the interstate transportation of natural gas under Section 1(b) of the Natural Gas Act.

34 FERC at 61,412 (citations omitted). Moreover, in Panhandle Eastern Pipe Line Company, Opinion No. 275-B, 42 FERC ¶ 61,076 (Jan. 27, 1988), appeals pending, Michigan Consolidated Gas Co. v. FERC, D.C. Cir. No. 88-1062, et al., the Commission made a similar finding to that in ANR and further cautioned that

> In reaching this conclusion, we are simply stating that a State cannot exercise whatever jurisdiction it has over a by-pass transportation service performed by an interstate pipeline when to do so would effectively provide the state with the power to "veto" our orders . . . .
>
> In other words, irrespective of any local effects resulting from the by-pass, we believe that the transportation service at issue here essentially concerns Federal interests, that is, those embodied in developing interstate transportation policy that provides consumers with a variety of supply options by promoting a competitively priced spot market for natural gas . . . .

Id. at 61,349.

In sum, the emerging threat of LDC bypass on an extensive nationwide scale can be attributed to two recent trends emanating from FERC. First, FERC has abandoned its long-held policy disfavoring bypass and adopted, in its place, an absolute free-market competition policy that emphasizes short-term economic gains over long-term rate impacts and service needs. Second, FERC has interpreted its own jurisdiction over the new form of bypass arrangement -- transportation-only bypass -- to be not only comprehensive but exclusive under the Natural Gas Act, and thereby has foreclosed the States from protecting the local public interest and performing their own balancing of the competing interests at stake in a bypass case. At the federal level, LDC bypass is now the name of the game and, as described below, the stakes of this game are enormously high for our Nation's natural gas consumers.

II. THE COSTS AND CONSEQUENCES OF BYPASS

The next topic addressed is why the problem of LDC bypass merits the attention -- and, AGD hopes, action -- of the United States Congress. In other words, what are the consequences, both short and long term, of bypass, how pervasive are these consequences, and how inevitable?

The most obvious and direct cost of LDC bypass is the very loss of a large customer from the utility's system. All LDC customers contribute, through their payment of rates, to the utility's fixed costs. When a customer leaves the system, the utility temporarily loses that portion of its cost recovery and, when it next files for new rates, must recover the costs previously carried by the departed customer from its remaining ratepayers. Thus, in the short term, the utility loses money and, in the long run, its remaining customers' rates increase.

The magnitude of this rate impact strictly from net revenue losses was explored recently in a study performed by a nationwide group of LDCs, of which AGD is a member. See Attachment A. The anonymous participants in the study -- a random cross-sample of LDCs of various sizes located in all regions of the country -- were asked to assume that those industrial customers who are "reasonably susceptible" of bypassing the LDC did so, and to calculate the (1) net revenue loss and (2) resultant increase in remaining firm customers' rates. The results varied widely. In one case, the distributor estimated approximately a 21% increase in its rates; the overall average was 7%. This study involved typical local gas utilities; the direct costs to customers of smaller LDC systems that might have but a single large industrial customer could be assumed to be at least as great.

The direct revenue-loss consequences of LDC bypass are only a small portion of the story. Substantial additional costs, though harder to quantify, would result from the LDC's loss of load balancing flexibility that comes with large, steady, year-round and fuel-switchable industrial consumers of gas. LDCs utilize their industrial loads to help keep their average cost of gas down for all customers, i.e., by increasing less secure, short-term purchases of gas on the spot market, by increasing the load factor under their pipeline firm sales contracts, in general by having a more flexible demand and consequent ability to diversify their mix of supplies. To the extent industrial load is lost, the LDCs' markets become comprised of seasonal, high priority residential and commercial consumers. The LDCs' supply needs become more volatile and heavily dependent upon seasonal and peaking services such as storage, liquified natural gas (LNG), propane-air facilities, and other so-called "peak-shaving" sources of supply, all of which are vastly more expensive than spot market and even pipeline sales supplies. Thus, the LDC's cost of gas to its remaining ratepayers is destined to increase along with their contributions to its fixed costs.

On an aggregate level, the costs described above are all attributable to the fundamental consequence of bypass -- the ultimate segmentation of the end use market for natural gas. The problem becomes a spiral, for the more industrials that bypass a utility's system, the more the LDC's rates go up, making it even less able to compete with alternate suppliers and, thereby, encouraging still more of its industrial load to leave the system. The LDC is left to serve primarily the small, non-fuel-switchable residential and commercial customers, and the end user market becomes "divorced" or segmented. Proper load balance, traditionally a concern of the Commission (see discussion of Natural Gas Pipeline case, supra) will have been lost and, as a consequence, distributors will be still less able to compete in the "spot" marketplace for the most competitively priced supplies of gas. Thus, the Commission's supposedly pro-competitive policy is actually just as anti-competitive as the discriminatory transportation programs that were condemned by the D.C. Circuit Court of Appeals in the Maryland Peoples' Counsel cases,[6] which provoked the Commission to embark upon its Order No. 436 odyssey in the first place.

III. H.R. 4089 -- A FAIR COMPROMISE

Finally, the AGD member companies would like to express their strong support for the legislation pending before this Subcommittee entitled "The Natural Gas Transition Act" -- H.R. 4089 -- as truly the most fair and equitable response to the problem of federally-sanctioned, indiscriminate bypass of local gas utilities. As the preceding remarks here indicate, for most distributors, the best of all possible worlds would be a complete prohibition of all bypasses to which an LDC objects. Recognizing the unpopularity of such a position with most other parties, however, as well as the practical realities of achieving that goal, the AGD companies are willing to support an alternative that truly addresses the process of bypass review, by ensuring that (1) the appropriate state or local regulatory authority is allowed to make a public interest determination, and (2) to the extent LDCs are exposed to competition for service to their industrial customers, it will be in a context in which the LDCs' remaining customers will not have to suffer unduly the consequences of such competition.

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[6] In the Maryland People's Counsel series of decisions, the D.C. Circuit struck down certain FERC-sponsored pipeline transportation programs that allowed pipelines to target transportation (and, thus, access to cheaper gas supplies) to low-priority, fuel-switchable markets that otherwise could be lost to alternative fuel, on the ground that such programs unfairly denied equal access to LDCs and their high-priority residential and commercial customers. See Maryland Peoples' Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985); Maryland Peoples' Counsel v. FERC, 761 F.2d 780 (D.C. Cir. 1985).

H.R. 4089 comes substantially short of prohibiting bypass in all instances. First, the bill has a prospective effect only; it does not affect the many bypass arrangements and direct pipeline-end user services already in place. Second, as to future proposals, bypass will be prohibited only where either (1) the state public utility commission (or other, analogous local regulatory authority) makes a certification that the bypass would adversely affect the present or future interests of the remaining customers on the LDC's system, or (2) the LDC itself files a protest and is willing to provide transportation service to the end user seeking the bypass under the terms set by the LDC's state or local regulatory authority. Thus, if the state or local commission does not oppose the bypass, and if the LDC is unwilling to offer transportation service to the end user (by which the end user could get competitive supplies of gas), then the bypass could take place.

Clearly, H.R. 4089 does not insulate LDCs from the pressures of healthy competition. As a preliminary matter, this legislation does not address in any respect the competition

LDCs face from alternative energy sources, such as fuel oil and electricity. Thus, competition remains fierce at the burner tip.

With respect to competition from natural gas pipelines, H.R. 4089 shifts the issues of whether and how much competition is appropriate for an LDC from the federal to the local level, where the implications of such competition can best and most accountably be assessed. The state or local regulatory authority, by virtue of its statutory certification power, is given the opportunity to determine whether competition in the form of a bypass would be advisable or would unduly harm the LDC's remaining customers. This is precisely where such decision should lie, for the local regulators are in the best position to both evaluate the impact of the bypass and determine if the costs to the utility and its other customers would outweigh the benefits to the industrial end user seeking the bypass.

If the state or local commission does not make a certification to FERC that would prohibit the bypass, then the LDC is explicitly subjected to competition from other gas sources. Under H.R. 4089, the LDC itself may only prevent the bypass if it is willing to offer transportation service to its end use customers on terms and conditions established pursuant to state law. With such transportation from its gas utility, the end user is then free to seek alternative sources of gas supply and, thus, the LDC remains subject to competition for its sales gas.

In sum, the issues raised by LDC bypass are really issues of cost allocation, and H.R. 4089 puts the task of balancing the competing interests of large industrial vs. residential, commercial and small industrial natural gas consumers where it belongs: at the state level. If industries feel that they are paying too much for natural gas service from their local utilities, the proper forum to address these concerns is with the state or local regulatory authority that sets the utilities' rates. The regulatory agency, as an instrument of local government, must be sensitive to the needs of all its constituents. If a big industrial usor feels that it must obtain a lower-priced gas supply than the local utility could provide, then the state or local regulator is equipped to force the LDC to offer a competitive transportation rate, so that the industry may obtain less expensive gas supplies elsewhere. Alternatively, the state authority could refrain from making the statutory certification to FERC and at the same time refuse to permit the LDC to offer transportation, in which case the bypass would, in all likelihood, take place. Moreover, the spectre of plants closing, losses of jobs, etc. is particularly compelling at the local level. Thus, the local regulatory authorities are fully equipped to prevent big industrial users from suffering ill effects from the restraint on LDC bypass contained in H.R. 4089.

In conclusion, AGD would just like to add that there have been charges recently -- from no less than the Chairman of FERC herself -- that LDCs, as supposedly the last "monopolies" that remain in the gas industry, are simply unwilling to compete or to work toward offering their customers a better, cheaper service. As far as the AGD companies are concerned, nothing could be farther from the truth. AGD members have been working diligently with both their state and local regulatory authorities and their industrial customers to develop new services, fine tune rate design, and participate in the spot market for the most competitively priced supplies of gas. At the same time, it cannot be forgotten that LDCs, as state-regulated public utilities, are monopolies and that a state or local determination has been made that a regulated monopoly is the most efficient, most environmentally sound, most equitable way to distribute natural gas at the local, retail level. The deregulatory policies emanating from 825 North Capitol Street cannot change this fact, and FERC's recent intrusion into state and local regulatory matters merely harms, rather than helps, the consumers whose interests it is supposedly bound to protect.

Atlanta Gas Light Company/P.O. Box 4569/Atlanta, Georgia 30302/Phone 404-584-4000

October 4, 1988

The Honorable Wyche Fowler, Jr.
Room 204
Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Fowler:

At the Energy Regulation and Conservation Subcommittee's hearing last week on natural gas bypass legislation, several references were made to the fact that Atlanta Gas Light Company now receives pipeline service from the East Tennessee Natural Gas Company system. Atlanta's action in obtaining service from East Tennessee was described as a "bypass" of its traditional interstate pipeline suppliers. The point was made that Atlanta's action is no different from that of a pipeline bypassing a local distribution company (LDC) to serve directly a large industrial customer of the LDC. The conclusion drawn was a simple "if it is fair for an LDC to bypass a pipeline, then it should be fair for a pipeline to bypass an LDC."

We respectfully submit that our actions vis-a-vis the East Tennessee connection in no way support the conclusions drawn by witnesses supporting bypass of LDCs and opposing the pending legislation. Accordingly, we are submitting this response and request that it be made a part of the Subcommittee's hearing record on S. 1998 and S. 2313.

Mr. Nicholas Bush, representing the Natural Gas Supply Association, testified that Atlanta Gas Light Company had bypassed Southern Natural Gas Company by building a pipeline to the Tennessee border to receive gas from East Tennessee Natural Gas Company. Atlanta Gas Light Company disputes this testimony. Our three suppliers, Southern Natural, Transcontinental Gas Pipeline Corporation and South Georgia Natural (a wholly-owned subsidiary of Southern Natural Gas Company), have not made available any significant additional contract demand since 1971. Southern Natural's service to us has not been displaced or "bypassed"; rather they have been unable to provide the additional service previously mentioned.

Our suppliers have been unable to provide needed and requested additional service. Atlanta Gas Light Company has been in a tremendous growth phase for approximately the last ten years. The majority of this growth has taken place in the northern metropolitan Atlanta area. Due to this tremendous growth, we have had the need to increase our contract demand to meet the increasing demand for natural gas service. The three aforementioned suppliers of Atlanta Gas Light Company have not made available any additional contract demand to meet the needs of the growing public which we have an obligation to serve. This has been our testimony on several occasions as follows: The East Tennessee Natural Gas Company certificate proceeding, Docket No. CP86-275-000, record at 3 of AGLC's motion to intervene; Southern Natural Gas Company's Rate Proceeding, Docket RP83-58-000, record at 455; Southern Natural Gas Company's Rate Proceeding Docket RP86-63-000, record at 5349 and 5353; and Southern Natural Gas Company's Rate Proceeding Dockets RP86-63-000 and RP86-114-000, record at 2 and 3 of Reply Testimony of Mr. Joe T. LaBoon.

We presently receive approximately 80% to 85% of our total throughput on Southern Natural Gas Company's system. This includes gas purchased by our Company and customer owned gas. In a bypass situation, all or the majority of this purchased or transported gas service would be displaced by another provider. With the addition of East Tennessee Natural Gas Company to our mix of supplier pipeline companies, we did not displace the sales or transportation services provided by Southern Natural, Transco or South Georgia. The level of service required remained approximately the same, with East Tennessee basically providing the additional contract demand needed to serve the customers added due to growth. Additionally, since the majority of our growth took place in the north metropolitan area of Atlanta, East Tennessee was in a strategically superior position to serve.

There are several obvious differences between Atlanta Gas Light's connection with East Tennessee and the typical interstate pipeline bypass of an LDC to serve large industrial customers of an LDC. First, our pipeline suppliers were unwilling or unable to supply us. LDCs are not seeking protection from interstate pipeline bypasses where they, the LDCs, are unwilling or unable to provide service. Second, Atlanta continues to receive and pay for service from our historical pipeline suppliers. In contrast, pipelines which hook up directly to an LDC's industrial customer typically remove that industrial customer as a revenue contributor to the LDC's system costs. And, finally, our connection with East Tennessee was subject to rigorous FERC and Georgia Public Service Commission review. Whereas, FERC's policies today permit virtually unfettered bypass of LDCs and preempt state or local regulatory review.

I hope this information clarifies the Atlanta Gas/East Tennessee situation. We certainly appreciate your participation at the hearing last week and hope you will give serious consideration to proceeding quickly with legislation to modify the bypass ground rules next year in a way that gives state authorities some significant power over this subject which has clear and substantial local consequences. Please let me know if we can assist you further.

Thank you.

Very truly yours,

Charles W. Bass

Charles W. Bass
Vice President
Governmental & Regulatory Affairs

jsc

CHEMICAL
MANUFACTURERS
ASSOCIATION

WRITTEN STATEMENT

OF THE

CHEMICAL MANUFACTURERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

OF THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

ON

S. 1998 AND S. 2313

SEPTEMBER 29, 1988

2501 M Street, NW 202-887-1100
Washington, D.C. 20037 Telex 89617 (CMA WSH)

I. Introduction

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose member companies represent more than 90% of the productive capacity of basic industrial chemicals in the United States. The chemical industry is highly energy intensive and relies on energy sources for both fuel and raw materials. For this reason, the subject of this hearing, natural gas bypass, is of vital interest. CMA appreciates this opportunity to submit comments.

The chemical industry is the largest industrial consumer of natural gas. CMA's member companies account for over 25% of industrial gas consumption and 10% of total U.S. natural gas use. As both a raw material, or feedstock, and as a process fuel, natural gas supplies are critical to the operations of the domestic chemical industry. Over 50 percent of chemical industry use, approximately one trillion cubic feet per year, is essentially non-substitutable. CMA members depend on both the interstate and intrastate natural gas systems for supplies.

II. Concerns with Proposed Legislation

CMA is concerned that proposed legislation limiting bypass will have a negative impact on the chemical industry's ability to obtain competitive natural gas service and rates for its operations.

Both S. 1998 and S. 2313 would potentially eliminate the option of end users to bypass local distribution companies (LDCs) where appropriate to secure more competitive natural gas rates and service. CMA believes these "anti-bypass" bills would be counter-productive, forestalling the benefits of bypass options not only to industrial users but to all customer classes of LDCs. Therefore, CMA opposes S. 1998 and S. 2313.

The benefits of bypass opportunities are shared by all natural gas consumers served by the LDC. Large volume industrial users who gain access to alternative, more competitively priced gas through a bypass arrangement are clearly better served, as are their customers. All end users, however, benefit from the increased incentive for LDCs to be competitive. As a result, the efficiency of natural gas markets is improved. Alternative supply options increase pressure for market-based prices from the wellhead to the burner tip. Anti-bypass legislation, such as S. 1998 and S. 2313, would further insulate LDCs from competition and would remove an important incentive for improved service at lower rates, thus harming all consumers and undermining the international competitiveness of U.S. industry.

CMA believes that claims of "unfettered" bypass by proponents of the legislation are grossly overstated. Despite the potential gains to industrial end users that are able to make such LDC bypass arrangements, few bypasses actually occur. Proponents of anti-bypass legislation also argue that Congress must adopt a "public interest test" in determining if bypass should be allowed. Yet, the Federal Energy Regulatory Commission (FERC) is charged with determining the public interest in energy regulation. FERC has stipulated that an interstate pipeline cannot bypass an LDC unless the FERC determines (based on an extensive public record developed by all interested parties) that to do so would be in the overall public interest. Bypass has occurred only where such a finding was made. In fact, anti-bypass legislation could over-ride previous "public interest" determinations in order to protect the LDC.

Most industrial end users, if economically coerced by an LDC, can substitute alternative fuels for natural gas. If this occurs, or if the industrial user is forced to shift its operations or cancel an expansion, the LDC, the pipeline serving it, and remaining gas customers will suffer. Thus bypass serves as an essential check on the monopolistic practices of LDCs. Such a check is in the interest of all consumers.

The market efficiencies gained by chemical industry end users' ability to bypass LDCs are demonstrated by three recent examples. These examples show that bypass often does not have to take place, but provides a real incentive to the LDC to negotiate efficient and competitive rates and service.

o In Virginia, a chemical plant's petition for bypass helped its plant negotiate market based terms from an LDC. A plant that primarily used No. 6 Fuel Oil (and which was not connected to the LDC) approached the LDC about transporting gas from an intrastate pipeline to its boilers. Although the intrastate's meter was on the plant's property, and the distance to transport was about 1200 feet, the plant found the LDC's transportation charge exorbitant: $0.567/MCF versus $0.07/MCF charged by the intrastate pipeline. The plant petitioned the Virginia State Corporation Commission to hook up directly to the intrastate line. The LDC opposed the petition. Ultimately, the LDC and the plant settled, and an LDC gas line was built to the plant. The threat of competition, presented by the intrastate pipelines' lower rates enabled the plant to secure reasonable rates and service.

- In Ohio, an LDC affiliate of an interstate pipeline controlled natural gas supply to local plants. These industrial users, with large, steady demands provided a base load which subsidized the entire LDC system. Despite efforts to negotiate, the LDC's rates remained non-competitive. When open access transport became available, reasonable rates were made available on the interstate lines. However, the LDC transportation rates were still in excess of $1.00 per MMBtu even though the LDC transport was less than 5 miles to several large industrials. In addition to high rates, the LDC required minimum purchases subject to take or pay penalties for any transport volumes. The only alternative for industrial users was to purchase LDC system gas at more than $5.00 per MMBtu.

Because two LDCs can operate in the same service region in Ohio, one of the major industrial chemical plants eventually obtained a pipeline connection from another interstate through a newly established LDC. The bypass was approved by the Ohio Public

Utilities Commission, and activated a competitive market for gas. Local gas producers were able to sell their production to the new LDC at market prices. The original LDC had maintained a captured shipper status over the producers, paying low prices while keeping the selling price high.

The initiation of competition in this case benefitted both the suppliers and end users. The original LDC altered its approach to marketing and gas acquisition and instituted actions to reduce its overhead costs. Its parent interstate pipeline company also grew more responsive to the market conditions faced by the affiliate.

o In New Jersey, a chemical plant is located such that an interstate pipeline crossed the plant property. The plant is served by an LDC whose facilities consist of a tap off the interstate and a few feet of pipe to its metering facility.

The plant had proposed using open access transportation to purchase natural gas in the Gulf Coast spot market and ship it via the interstate and across the few feet of LDC system. The LDC agreed to "transport" the gas at a charge of $.50 per MMBtu, but the LDC also wanted exclusive rights to purchase the gas for an additional charge of $.03 per MMBtu. Without the threat of bypass, the LDC would be able to continue to insist on brokering rights, which results in loss of revenue, disadvantaging the entire customer base. The plant has attempted to reopen negotiations with the added incentive of additional gas demand for its cogeneration unit. If the LDC were assured of no bypass, its charges will remain excessive; the likelihood of achieving additional benefits from the cogeneration unit may also be lost.

III. Summary

CMA opposes the anti-bypass bills, S. 1998 and S. 2313, because they are counter-productive, and hinder the emergence of competition in natural gas markets. The objective of any bypass alternative is to achieve market-sensitive rates and improved transportation service. If this objective is obtained through negotiations with the LDC, the need for actual bypass arrangements is greatly reduced. In fact, the number of actual bypasses to date is small. However, when the LDC comprehends that the possibility of a bypass alternative is real, rates and service to all end users are enhanced. For these reasons, Congress should not further insulate LDCs from competition.

Comments of the
CONSOLIDATED NATURAL GAS COMPANY
Regarding
CONCERNS RELATED TO INTERSTATE BYPASS
Submitted for Inclusion in the Record
of the
Hearing before the
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION
of the
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
September 29, 1988

INTRODUCTION

Consolidated Natural Gas Company ("CNG") appreciates the opportunity to submit for the record of this hearing comments supporting a legislative solution to the interstate bypass problem. For the information of the Subcommittee, we wish to note that CNG operates one of the country's largest fully integrated natural gas systems.

Our primary marketing areas for natural gas are Ohio, Pennsylvania and West Virginia, where our retail distribution companies are located, and also New York, New Jersey and other States in the Northeast. Our exploration and production subsidiaries find and produce gas and oil throughout the Appalachian, Southwestern and Rocky Mountain regions, including in the States of Louisiana, Oklahoma, New Mexico, Colorado, Wyoming and Texas.

In other words, we are a producer, a pipeline company and a distributor of natural gas, and our activities encompass all segments of the market. We believe that this multipart role permits us to speak with unusual objectivity on the subject of bypass. We are convinced, from our experience as an integrated gas company, that what is good for the gas consumer is ultimately good for the gas industry.

CONGRESS SHOULD ADDRESS THE BYPASS ISSUE

CNG believes that the unfettered bypass of local gas utility companies by interstate pipeline companies is emerging as a problem with serious implications for gas consumers generally, and that a federal legislative solution to the problem is called for. The issue is too important to be left to Federal Energy Regulatory Commission ("FERC"), whose evident tendency is to favor large industrial customers at the expense of small commercial and residential customers.

It is important for Congress to act in order to assure that the States retain a guiding hand with respect to the bypass issue. FERC has not demonstrated a depth of expertise regarding the local distribution companies ("LDCs"), their functions and their customers. This is not surprising because the LDCs traditionally have been creatures of State law, and have been regulated by the States, in furtherance of the public interest.

It is arguable that the States already have the authority to control bypass transactions in their jurisdictions. However, it is becoming apparent that expensive and time-consuming litigation may be required to demonstrate that the States do, indeed, have the necessary powers to address the bypass issue. We urge Congress to act expeditiously to clarify the scope of the States' authority with respect to the bypass issue, and to define the parameters in which FERC may act.

It is worth emphasizing that LDCs are regulated monopolies. This is not necessarily a status which each LDC would seek if that status were not already established. But it is a fact which needs to be taken into consideration by Congress, as it contemplates the potential for change. The service obligations of LDCs have been defined by years of statutes, regulations, and case law in each State, as an expression of State policy. In a nutshell, those policies require LDCs to provide reliable service at reasonable rates to the public at large -- not just to customers of their choosing, but to all comers. Congress, before permitting FERC arbitrarily to modify these principles, should make sure that the various legitimate interests are given voice, and clearly understood.

BYPASS POSES RISKS TO THE PUBLIC, AND ALSO TO THOSE WHO CHOOSE TO ENGAGE IN SUCH TRANSACTIONS.

CNG is committed to the concept that, as the industry continues to change, the needs of all of the customers served by LDCs ought to be addressed. Further, we are concerned that unregulated pipeline bypass of LDCs is generally harmful to most LDC customers, despite the short-term benefit which may accrue to a few fortuitously located industrial customers.

Bypass does not help those who cannot do it, and most of the customers of LDCs cannot -- they are neither geographically situated near a pipeline nor do they have the appropriate size and types of load or the operational capability. Thus, all of the LDCs' residential and many of the LDCs' commercial customers are ineligible for bypass, but could be faced with the responsibility for higher fixed costs as a result of large industrial customers dropping off an LDC's system.

The most frequently discussed problem with bypass is that, without some sort of balancing test, such transactions will result in a situation where large customers no longer are served by LDCs, and the remaining customers will experience higher costs because there will be fewer of them. Furthermore, in some cases bypass results in duplicative facilities and extra costs to the public associated with support of unneccessary facilities.

Another risk to the customers remaining after bypass, as well as to those who choose to leave the system, has to do with the gas supply acquisition policies of LDCs. These policies are commonly reviewed by State public utility commissions under State "least-cost procurement" statutes and regulations. LDCs are obliged to match supply and demand as much as possible and may recover only for prudently incurred costs. In other words, LDCs whose customers leave as a result of bypass must rearrange their purchasing practices to reflect less demand, or be declared imprudent and penalized accordingly.

The conditions which make bypass attractive to certain customers are essentially short-term, and do not lend themselves to contracts in excess of one year. Furthermore, to take advantage of bypass opportunities, a customer must have the operational capability to receive the gas as if it were an LDC. These conditions and circumstances may be fleeting. The customer may be faced with great difficulty in meeting its energy needs when spot prices go up because there is less gas or because more parties are chasing the same gas, when there are supply interruptions, or when its own operational capabilities are not what it thought.

State public utility commissions may not permit LDCs to stand ready to serve -- to reserve supplies from pipelines -- unless those for whom the supply is reserved are willing to pay for it. Certainly the remaining LDC customers should not be expected to pay the cost of an LDC standing ready to welcome the departed back into the fold.

Thus, many customers who do bypass deals, for a relatively minimal short-term economic benefit, could find themselves with no supplier capable of keeping them in service over the long run.

The argument that LDC customers ought to be permitted to accept this business risk ignores the fact that society has a very large stake in the process and in the outcome -- a stake which responsible regulation should be permitted to address, taking into account all the potential impacts, and not just the short term benefits to a few.

BYPASS SHOULD NOT BE PERMITTED AS A TECHNIQUE TO AVOID TAKE-OR-PAY OBLIGATIONS

Parties that will benefit from bypass -- producers, long-line pipelines and large end-users -- say that they advocate competition and flexibility in natural gas markets. These parties are the same ones who in other contexts are not always following free market principles. Producers, for example, have continued to enforce contract prices that far exceed current market prices. Large end-users have sought to avoid their entire responsibility for take-or-pay expenses or any other expense that may reflect the true, long-term costs of natural gas supplies. Long-line pipelines are seeking to pass through enormous take-or-pay liabilities to their traditional LDC customers at a time when there are no explicit constraints on bypass of these same LDCs. These practices can amount to what in other contexts is called a "price squeeze".

Pipeline suppliers should, at minimum, be prohibited from bypassing any LDC which is currently reimbursing that pipeline for past take-or-pay expenses. This rule also would retain for the State commissions the full discretion to charge take-or-pay related expenses to all of the LDC's customers that historically used the system.

ALTERNATIVES TO TRADITIONAL SERVICE ALREADY EXIST

What makes the interstate bypass problem especially ironic is that industrial customers contemplating bypass already have a wide array of cost-effective utility-provided alternatives to traditional retail service -- a range of services that is broader than at any time in history. Indeed, all States in which our LDCs operate permit such customers to choose between retail and transportation service, with or without standby or backup rights, and, if they have chosen transportation service, to acquire their own gas and have it moved by the utility if they do not want the utility to find the gas for them.

In other words, far from having a prix fixe meal, these customers can order a la carte right now. This growing flexibility is an integral part of the evolution already taking place in the gas industry. Despite the claims of a few gas users, the "threat" of unfettered bypass is not needed to assure the availability of a range of service options for industrial customers.

CONCLUSION

CNG recognizes that the industry is changing, and that there may well be circumstances where bypass and other manners of avoiding certain LDC charges may be appropriate. Such circumstances must be defined with care, however, and the definition of the circumstances is a process in which the State commissions must participate. It is neither feasible nor desirable for FERC to assume this role, even if it had the experience and expertise to do so.

Respectfully submitted,

David E. Weatherwax
David E. Weatherwax
Senior Vice President and
General Counsel

STATEMENT OF

THE INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS, AFL-CIO

TO THE

ENERGY AND CONSERVATION SUBCOMMITTEE

SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

CONCERNING S. 2313

THE NATIONAL GAS TRANSITION ACT OF 1988

BYPASS OF NATURAL GAS LOCAL DISTRIBUTION COMPANIES

SEPTEMBER 28, 1988

STATEMENT OF
THE INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS, AFL-CIO
TO THE
ENERGY AND CONSERVATION SUBCOMMITTEE
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
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BYPASS OF NATURAL GAS LOCAL DISTRIBUTION COMPANIES

SEPTEMBER 28, 1988

The International Brotherhood of Electrical Workers, IBEW, represents approximately 850,000 members in the United States. In addition to our concern for our members as consumers of natural gas we are also distressed by the potential negative impact on our more than 30,000 members, who are employed by natural gas distribution utilities, by the decisions of the Federal Energy Regulatory Commission as they pertain to the bypass of local distribution companies by the pipeline companies to serve large industrial customers. Something must be done to restrict such decisions by the FERC.

Under present conditions the FERC encourages the bypass of the LDC by pipelines selling directly to large natural gas users at rates that are well below those authorized by the State regulatory body. The residential consumer and other small users are left holding the bag for the cost of operating the LDC including the piping system, operating cost, and overhead. This is extremely unfair to the residential consumer and small users who, in conjunction with the LDC, have paid for the natural gas pipeline transmission system over the years.

Government agencies should be devoted to equitable treatment for all consumers and not allow a select few to skim the cream off the top. As large industrial load leaves the LDC it will inevitably lead to higher prices for those captive consumers remaining on the system. The pipeline companies will obtain a large portion of the industrial load without the attendant costs associated with service to all types of consumers, large and small, ultimately leading to an inefficient distribution system.

The FERC, acting out the game plan of the 1980's, has devoted itself to the deregulation of the natural gas industry without legislative authority. Their rulings in allowing the bypass of LDC's evidences a string inclination toward decontrol over the interstate pipeline suppliers while hamstringing the LDC and disrupting a system that has provided fair pricing to all natural gas consumers. Further, the FERC bypass policy is a usurpation of the authority and responsibility of the State regulatory body which must rule on rates for the remaining consumers of the LDC. Equitable rate rulings are impossible when the FERC allows a bypass to occur without consideration by the State regulators.

The current deregulation binge in our nation has led to substantial inequities for various consumers. When deregulation hit the telecommunications industry only a few gained at the expense of many. Big business realized reduced telephone rates and some long distance rates were reduced while the cost of local telephone service has more than tripled in most cases. Thus, the burden has been placed square on the backs of residential users. The telephone system that was the best in the world is rapidly deteriorating as customer service is displaced by the need to compete. Thousands upon thousands of jobs have been exported or eliminated as competition has forced the manufacture of telephone equipment to foreign countries and as service to the customer becomes less a priority.

Similar stories surround the deregulation of most other industries in our recent past. Airline deregulation has resulted in fares that are inequitable to those who lack the flexibility to schedule flights well in advance or during off peak hours. Deregulation of the banking industry can be blamed for outrageous banking practices, ridiculous fees, and even bank failures. The list goes on and on with benefits derived by a few at the expense of many.

We need not add to this list of inequities by failing to halt the activities of the FERC in allowing the bypass of LDC's by pipeline suppliers to serve large users. As an agency of the Federal Government they should be required to treat all gas consumers equitably. Pipeline suppliers should not be allowed to pick the cherries while leaving the pits for the LDC's.

The IBEW believes that S. 2313, introduced by Senator Cranston, is a solid step forward in the equitable treatment of all classes of natural gas consumers and in retaining a reliable distribution system. We are supportive of this type of legislation and we urge your favorable consideration.

STATEMENT OF
KERN RIVER GAS TRANSMISSION COMPANY BEFORE THE SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION OF THE COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
SEPTEMBER 28, 1988

Kern River Gas Transmission Company (Kern River) welcomes this opportunity to present its views to the Subcommittee on Energy and Conservation of the Committee on Energy and Natural Resources as the Subcommittee undertakes its consideration of S. 1998 and S. 2313. Kern River is presently a party to litigation before the Federal Energy Regulatory Commission in which issues such as those addressed by these two bills have been raised. Kern River submits that neither S. 1998 nor S. 2313 should be favorably acted upon by the Subcommittee.

Kern River is a joint venture of The Williams Companies and Tenneco Inc. It was formed for the purpose of constructing an interstate natural gas pipeline from an interconnection with Northwest Pipeline Corporation in southwestern Wyoming to Kern County, California, to transport and deliver new supplies of gas to be used in the recovery of "heavy" crude oil in a process known as thermally enhanced oil recovery (EOR) and in related electric cogeneration operations. Kern River will offer transportation services only and will not be a seller of gas.

1. Introduction to the California EOR Market

The EOR market in Kern County exists because most Kern County crude oil is too thick to be pumped from the ground by conventional means. Therefore, the oil must be heated to flow more easily. Oil producers presently primarily burn oil to generate steam that is injected into the oil reservoirs to heat the crude and make it flow to the pumping wells. Unfortunately, because EOR producers have not had a reliable, competitively priced alternative fuel available to them, they must consume as much as 30%-40% of all of the oil they remove from the ground to produce steam to pump into the reservoirs. Replacing oil with natural gas for the generation of steam in the EOR process will mean that 100% of the oil pumped can be refined, not just 2/3 or less, and used as gasoline or other products. From a national perspective, this means that oil imports can be reduced by an amount equivalent to the additional amount of heavy crude that is made available for processing and marketing.

Kern County is one of the most prominent sources of oil in the country. In fact, if Kern County were a state, it would rank fourth in the nation in oil production. Three billion barrels already have been produced from Kern County's three largest heavy oil fields. There remain an estimated 3.2 billion barrels of recoverable reserves in Kern County.

The potential demand for gas for use in EOR production in Kern County is enormous and is generally acknowledged to be the largest foreseeable incremental demand in the United States. Estimates of the size of this demand range from 600 million to one billion cubic feet of gas per day in the 1990's. At these levels, the EOR demand would represent an increase of nearly 25% in the demand for gas in California, which is the second-largest gas-consuming state in the nation, and would be larger than the requirements of some of the country's largest cities.

EOR producers are seeking to substitute natural gas for crude oil in their operations because gas is less expensive to burn and cleaner for the environment. Burning gas is less expensive from a capital investment viewpoint because it eliminates the need to purchase exhaust gas scrubbers and other anti-pollution devices. It is less expensive from an operating cost standpoint because gas contains virtually no corrosive sulphates or nitrates, both of which reduce steam generator life and increase maintenance costs. Moreover, burning natural gas eliminates the need for disposal of sludge from exhaust gas scrubbers, which is not only expensive, but increasingly difficult. Five of the six sludge disposal sites in California are no longer available to EOR producers.

2. Interstate proposals to serve the EOR market

The potential size, longevity and service requirements of the EOR market make feasible the construction of a new interstate gas pipeline to serve it. Indeed, the major EOR producers told the FERC in a pleading filed January 22, 1986, that "[o]nly an interstate pipeline can provide the uninterrupted, long-term transportation of the reliable, competitively-priced supplies of natural gas that are needed for the California EOR operations." Thus, Kern River and other pipeline companies have proposed the construction of interstate facilities to serve this vast new market. Kern River has applied to the FERC under Section 7 of the Natural Gas Act for certificates of public convenience and necessity authorizing the construction and operation of its proposed pipeline. The FERC in 1986 consolidated Kern River's application with other, related applications for a comparative proceeding under the doctrine of Ashbacker Radio Corp. v. FCC, 326 U.S. 327 (1945).

The Kern River pipeline system will be approximately 837 miles in length. It will include 762 miles of buried 36-inch pipeline extending from a point of intersection with the existing interstate pipeline system of Northwest Pipeline Corporation (another Williams Companies subsidiary) in the southwestern corner of Wyoming, traveling southwestward across the states of Utah and Nevada, to a point approximately ten miles southeast of Bakersfield, California. From that point, the pipeline will divide into two 30-inch lines, one extending from the mainline approximately 28 miles northward into the Kern River oil field and the other extending 47 miles west/northwest into the oil fields on the west side of the San Joaquin Valley. The pipeline's proposed capacity is 700 million cubic feet of gas per day. The system's capacity can be readily increased to about 1.2 billion cubic feet per day with the addition of compression, but Kern River has not proposed to build its system with that expanded capacity. The estimated cost in 1986 dollars of the project as proposed is $719 million.

3. **Existing Service in the California Gas Market**

Natural gas service in California and in Kern County is presently provided by either Southern California Gas Company (SoCal Gas) or Pacific Gas and Electric Company (PG&E) within their respective, exclusive service territories. SoCal Gas is the largest natural gas distribution company in the United States and is part of the multifaceted Pacific Enterprises Corporation conglomerate, which includes oil and gas production, real estate and sporting goods firms. PG&E is the largest combined electric and gas utility in the United States. California is the second largest gas consuming state in the nation, but, unlike virtually all other states, no interstate natural gas pipeline crosses its borders. Gas presently is delivered to SoCal Gas and PG&E at California's borders by El Paso, Transwestern, and Pacific Gas Transmission Company (PGT), a wholly-owned subsidiary of PG&E. PG&E and SoCal Gas together transport or sell more than 98% of all the gas consumed in California.

Because of their enormous sizes and the configurations of their suppliers, SoCal Gas and PG&E do not fit the ordinary concept of a natural gas "distributor." Both companies own and operate hundreds of miles of large-diameter, high pressure pipelines; together they are the transmission network, as well as most of the distribution system, in California. No other person owns any facilities for the transmission of gas from the state's borders to its markets.

PG&E and SoCal Gas also control the capacity of the interstate pipelines that deliver to them at California's borders. The two companies together have under long-term contract every Mcf of the capacity of the El Paso, the Transwestern and the PGT pipelines to deliver gas to California.

Exhibits KR-31 at 2-3; EP-7 at 4; EP-9; TW-1 at 3; KR-31E. 1/ Thus, the contractually firm transportation capacity that EOR producers (and other utility customers) seek is simply unavailable to them because all interstate pipeline capacity serving California is committed to SoCal Gas and PG&E. Both utilities have indicated publicly that they have no plans to release any of that capacity because it is necessary to adequately serve their high-priority sales customers. Exh. KR-31A, Schedules 1 and 2; Hearing Transcript (Tr.) 10,063 - 10,067 (1/25/88).

4. S. 1998, S. 2313 and the EOR Market

Kern River's interest in the Subcommittee's consideration of S. 1998 and S. 2313 arises from the vehement opposition of SoCal Gas and PG&E, as well as of the Public Utilities Commission of the State of California (CPUC), to Kern River's attempts to obtain the necessary regulatory approvals for its proposed pipeline. SoCal Gas, PG&E and the CPUC have raised, among other contentions, "bypass" issues in the FERC proceeding concerning Kern River's (and Mojave's) proposal. These arguments include allegations that construction of Kern River's pipeline would create idle capacity on the California utilities' systems,

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1/ Throughout the remainder of this statement, Kern River will provide citations to materials contained in the record of the FERC proceeding on the Kern River application, captioned Mojave Pipeline Company, et al., Docket Nos. CP85-437-000, et al. This will enable the Subcommittee's staff to verify the accuracy of Kern River's statements if it wishes to do so. All of the material cited by Kern River has been subjected to cross-examination.

thereby imposing additional costs on and increasing rates to non-EOR customers of SoCal Gas and PG&E.

Both S. 1998 and S. 2313 are intended to prohibit or at least to greatly restrict direct service by interstate pipelines to gas consumers in so-called "bypasses" of local gas distribution utilities. It appears to Kern River that both pieces of proposed legislation are sufficiently broad that either, if enacted, would effectively proscribe or allow the CPUC to proscribe the service which Kern River proposes to provide to the Kern County EOR market.

In Kern River's view, S. 1998 and S. 2313 fail to properly recognize the fundamental purpose of government regulation of monopolies. Regulation of utilities exists because the provision of utility service is, to some extent, naturally monopolistic; that is, it is frequently more efficient for only one firm to provide the service than it is to have several providers. The objective of regulating such natural monopolies is to prevent monopolists from exploiting their economic power at the expense of their customers. Regulation is not and, to Kern River's knowledge, never has been imposed for the purpose of protecting monopolies from entry into their markets by competitors. Yet that is precisely what S. 1998 and S. 2313 would do.

Kern River believes that it is important for the members of the Subcommittee to understand that "bypass" occurs or is attempted generally either because (1) local authorities have established rate structures that require industrial customers to pay more than the cost of providing the service they receive, usually so that the additional revenue above the cost of service can be used to subsidize rates charged to other customers, or (2) the local utility is unable or unwilling to provide the quantity or quality of service that the customer seeking the bypass desires. Whether a bypass in any particular instance is economically efficient and therefore promotes the public interest is dependent upon the facts of each case.

Uneconomic bypass is unlikely to ever actually occur, even if it is proposed. If the local distributor of gas is willing and able to provide the desired service to the customer at a competitive, cost-based rate, the customer has no incentive to leave the distributor's system. If regulators permit the monopoly utility to respond to the competitive pressures of bypass and the local utility is in fact the lowest-cost supplier of the service sought by the customer, then bypass is highly unlikely to take place.

This point has been made repeatedly in expert economic testimony in the proceeding before the FERC regarding Kern River's proposed pipeline. It is perhaps best stated by Dr. Kenneth Heyer, an economist with the Antitrust Division of the United States Department of Justice in his testimony (Exhibit DOJ-1 at 34-35; Exhibit DOJ-10 at 3):

> Even if we assume, arguendo, that the utility system constitutes a natural monopoly, this alone would not necessarily warrant a legal prohibition of entry. Natural monopolists

> are generally able to deter entry by setting prices lower than any potential entrant's costs, but high enough to cover their own. Thus, allowing entry does not imply that inefficient entry will actually take place. And, if inefficient entry is unlikely to take place, the efficiency benefits from having a single firm produce the market's total output will not be placed at risk simply by certificating potential entrants. With respect to this proceeding, this implies that if the California utilities can serve the affected markets at lower cost than can the applicants, there is good reason to expect that they can prevent entry even if certificates are granted.

* * *

> If the applicants are granted certificates, a competition between them and the utilities will take place prior to actual construction of an interstate pipeline. The EOR producers will, in their own economic self interest, sign contracts with whoever offers them a lower price. If the utilities do indeed have a substantial cost advantage over the applicants, and if, as recent CPUC regulatory decisions strongly suggest--and the statements and testimony of the CPUC and the utilities support--the utilities have both the ability and the incentive to compete for the EOR business, then the utilities can and will offer prices below the cost of the applicants. Only if the applicants are willing to match the utilities' offer-- i.e., to charge prices that fail to cover their own costs--might it be in the interests of the EOR producers to sign contracts with the applicants. But, since we can safely assume that neither the applicants nor their creditors are interested in financing the construction of a pipeline that is expected to lose money, uneconomic bypass will not take place. Note that this result is obtained through competition in the marketplace. Denial of certificates is unnecessary.

Dr. Joseph P. Kalt, Professor of Political Economy at the John F. Kennedy School of Government of Harvard University and Assistant Director for Natural Resources at Harvard's Energy and Environmental Policy Center, agreed in his testimony before the FERC (Exhibit MP-69 at 3-4, 7-8):

> In fact, the [EOR market] provides precisely the setting in which competition can be relied upon as the arbiter between efficient, "economic" entry and wasteful "uneconomic" entry. This means that [an interstate pipeline] will only be undertaken if the benefits to the nation's economy that can be anticipated exceed the costs; and FERC should allow this competition to take place.
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> The potential of new entry into an industry is a desirable feature that benefits and protects consumers. If consumers cannot obtain the type of product they want (e.g., firm gas deliveries and/or reliable contract terms) or are paying a price in excess of cost, they can turn to a potential new supplier. In fact, the mere potential for entry is a potent force that can discipline an industry to provide the products consumers want at reasonable prices. It is precisely when barriers to new entry exist, that we should worry most about industry performance. Preventing entry is the surest way to create economic harm and protect inefficiency.
>
> The prospect of entry by new competition can spur intrastate gas distribution companies to improve their service offerings. Indeed, the California utilities' and the CPUC's efforts to respond to the needs of their customers have increased noticeably since the appearance of the pending interstate pipeline proposals . . . . Notwithstanding the relative ineffectiveness of such adjustments by the utilities and the CPUC, it would be inconsistent with the interests of the utilities' stockholders and other ratepayers for the utilities' management or the CPUC to fail to continue to respond with adjustments to rates and terms of service if [an interstate pipeline] is certified. By the same token, it would be inconsistent with the incumbent parties'

> interests for them to continue down their recent path if the threat of competition is removed by the FERC's failure to certify an interstate pipeline.

Because the merits of any bypass are so highly case-specific and because uneconomic bypass is so rare, generic legislation such as S. 1998 and S. 2313 inevitably will paint with far too broad a brush. The circumstances of the California EOR market that Kern River seeks to serve provide an excellent illustration of this point.

Proceedings before FERC related to the competing Kern River and Mojave applications have provided a forum for the affected local distribution companies (SoCal Gas and PG&E) and the interested state commission (the CPUC) to present all their evidence regarding the merits of Kern River's proposal. Those proceedings have encompassed four rounds of written testimony and discovery, cross-examination of nearly 100 witnesses during five months of trial-type hearings, more than 12,000 pages of transcript and hundreds of exhibits. The FERC will decide the case on the facts contained in this exhaustive record. It is difficult to conceive that generic legislation could reach a result more correct than the FERC will reach after consideration of all of the facts that have been placed before it in this proceeding. 2/

2/ Another proposal to build an interstate pipeline to serve the EOR market in Kern County was filed with the FERC in August, 1987 by Wyoming-California Pipeline Company (WyCal). WyCal submitted its application pursuant to the "optional expedited certificate" (OEC) regulations promulgated by the FERC in 1985 as part of its Order No. 436.

S. 1998 and S. 2313 both approach bypass as though it is entirely a matter of local concern. In most cases, however, the issues are vastly broader and involve important national interests. For example, in Panhandle Eastern Pipeline Company's proposed bypass of a local distributor to serve the steel manufacturing facilities of National Steel Corporation, the nation's interests in maintaining a viable, competitive domestic steel industry, in retaining jobs in the United States and in reducing the international trade deficit by enhancing the competitiveness of domestic industries are all important considerations that are far from local in character.

Likewise, the question of interstate pipeline service for the Kern County EOR market involves vital national interests, primarily our need to minimize our dependency on imported oil. Kern County's oil reserves are enormous, but the specialized production technique necessary to produce them is tremendously capital-intensive. Mobil Oil Corporation has stated that it has $250 million invested in just four oil fields in Kern County and it is only the fourth largest producer there. Exh. KR-2C, Schedule 1. Chevron U.S.A. Inc., another important producer in Kern County, has stated that full development of its properties will require capital investment of $2.5 billion. Exh. KR-2 at 6. Fuel costs account for two-thirds of the expenses of operating EOR facilities. Exh. KR-2C, Schedule 1.

It is thus not at all surprising that all of the major Kern County EOR operators have said that they cannot justify such enormous, long-term investments of their capital unless they are assured of reliable, firm, competitively-priced gas supplies and transportation over the life of their investments and that only a new interstate pipeline can provide them with such assurances. Exhs. DOJ-23; KR-27F; KR-2B, Schedules 1, 2, 3. In this light, it is clear that full development of Kern County's oil reserves and full realization of those reserves' potential for reducing the nation's imports of foreign oil are unlikely if the producers are denied the benefits of competition between an interstate pipeline and the California utilities for their business.

Kern River's proposal to serve the EOR market also involves interests important to states other than California. Construction of the project will provide substantial benefits to the economies of the areas through which it would be built. These benefits will accrue during construction in the form of construction jobs, expenditures by workers for goods and services in localities along the route and purchases by Kern River of materials and supplies from businesses all around the country. Exh. CS-25, Vol. II, pp. 4-57 - 4-59. Local jurisdictions in which the pipeline is located will benefit throughout the project's life from the approximately $16 million (computed at 1984-85 rates) of state and local property taxes that Kern River will pay each year. Exh. CS-25, Vol. V, pp. KR-112 - KR-113.

Perhaps more importantly, Kern River's pipeline will for the first time provide economic access to the California market for vast supplies of gas in the Rocky Mountain area of

Wyoming, Utah, Colorado and Idaho and thus has the potential for bringing even greater economic benefits to those states. The Wyoming Public Service Commission and the Wyoming Natural Gas Pipeline Authority have estimated that this region has a total natural gas resource of 144.5 trillion cubic feet, only 10% of which has been produced. Approximately 85% of these volumes are found in Wyoming. The annual rate of depletion of Rocky Mountain gas supplies is one-half of one percent. Production from the Rocky Mountain area thus could be sustained at 1984 levels for 167 years. Most of the other U.S. gas producing areas have a production life several times smaller than this. For example, most of the gas reserves in and around the Gulf of Mexico will be depleted in just 40 years. Exh. CS-19.

The Wyoming Public Service Commission has estimated that Wyoming presently produces only about two-thirds as much as it is capable of producing. Even during the winter heating season of 1986-1987, approximately 26% of the gas wells in the six largest gas-producing counties in Wyoming were shut in by their operators because of a lack of demand for the gas. Exh. CS-19. The State of Wyoming has estimated that if Kern River transported 350 million cubic feet per day of Wyoming gas to California, the state would realize more than $44 million in new tax revenues each year. Exh. WY-1 at 4. Considerations such as these have led the Utah Congressional delegation to express its unanimous support for the Kern River project in a letter to the chairman of FERC, to the adoption of resolutions of support for

Kern River by the legislatures of the States of Wyoming, Utah, Idaho, Washington and Oregon, and to expressions by the governors of Wyoming and Utah of support for Kern River at public meetings sponsored by the FERC's Staff.

Section 7 of the Natural Gas Act makes FERC the arbiter of the competing interests involved in proposals like Kern River's application for authority to build its pipeline. The "public convenience and necessity" standard of Section 7 requires a balancing of all relevant considerations from a national perspective. S. 1998 and S. 2313, however, would elevate each state's parochial interests to a higher standing than all other factors in the evaluation of proposals like Kern River's.

Many proponents of these bills apparently argue that this is appropriate because, in their view, FERC has given insufficient consideration to factors such as effects of "bypass" on local ratepayers or on the financial condition of the affected LDC. They also support this position with the contention that FERC has improperly intruded into state jurisdiction by asserting that transportation service "bypasses" are exclusively within FERC's jurisdiction under the Natural Gas Act. Neither of these arguments provides a basis for the proposed federal legislation that is now before the Subcommittee.

If FERC does in fact give inadequate consideration to any of the factors that are relevant to its decisions under Section 7 of the Natural Gas Act, then the appropriate remedy for those who are aggrieved by that omission lies in the courts of appeals on petitions for review of the offending orders of the Commission. Likewise, if FERC's orders approving transportation "bypasses" under the Natural Gas Act do in fact exceed its jurisdiction over interstate commerce under that statute, the proper remedy for aggrieved parties lies first in the courts, not in Congressional action.

Thus, the proponents of S. 1998 and S. 2313 would have the Congress "solve" a "problem" purportedly created by the FERC even though the lawfulness of FERC's actions can be reviewed by the courts. The bills now before the Subcommittee would eliminate in an inappropriate preemptive strike the federal forum before which all factors relevant to individual interstate pipeline "bypass" proposals are weighed in striking the balance of the "public convenience and necessity." However, the record that the FERC will review in reaching its decision concerning the EOR market convincingly illustrates that "bypasses" must be judged on their individual merits and that the virtual blanket veto power that the bills now before the Subcommittee would give to each state cannot be justified.

For example, in evaluating Kern River's proposal, the FERC will note the differences of opinion within the California state government itself about the merits of interstate service for the EOR market. Part of the FERC's record is the 1987 Biennial Report of the California State Energy Resource Conservation and Development Commission (known as the California Energy Commission or CEC), which has been adopted by Governor

Deukmejian of California as the statement of California's official state energy policy. Exh. BX-13. That report concludes that the FERC should allow the market to determine whether one of those pipelines will be built. The CEC's conclusion is based in part on its Biennial Fuels Report of September, 1986, in which it examined the EOR market in considerable detail. The CEC there made the following observations (at p. 57):

> A new interstate pipeline in California would provide competition for bulk transportation of gas, which is now lacking in the state. Increasing competition tends to lead to lower prices. Competition provides a powerful economic incentive to increase economic efficiency and thus reduce costs. State and federal utility regulators have long recognized the value of economic incentives to supplement regulatory oversight as an assurance of utility performance. In addition, competition acts as a spur to develop desired new products or services in order to capture greater market share. For example, the threat of an interstate pipeline was instrumental in the CPUC's decision to order contract carriage by California utilities.
>
> Even if a new interstate pipeline into California were to be limited to serving TEOR producers, the competition to utilities that it would engender would benefit all utility customers. The transmission facilities that a utility would use to serve TEOR customers in large part are the same facilities used to serve other customers. Thus, utility transmission cost reductions made in an effort to become or remain competitive with an interstate pipeline to serve the TEOR market would likely reduce costs to serve other customers. CPUC oversight of the utilities could assure that the benefits are fairly distributed, so that benefits are not disproportionately allocated to TEOR customers.

The FERC also will consider admissions by SoCal Gas and PG&E that they cannot and will not provide the EOR producers with the contractually firm, uninterruptible transportation service which the customers have repeatedly and consistently said that they need and desire. The utilities simply cannot give EOR operators assurances that transportation of the operators' gas will not be interrupted from time to time. Exh. SG-1 at 9; Tr. 11,271 (2/10/88). The record also contains evidence that the EOR producers have virtually unanimously indicated that they consider competition for service of their requirements, rather than service solely by the utility monopoly, to be essential to the market's development. Exh. KR-2C, Schedules 5, 8, 11. The producers are unconvinced that the utilities' and the CPUC's efforts in the years since the Kern River project was conceived to provide competitively priced, although interruptible, service to the EOR market will survive a defeat of the interstate pipeline proposals.

Also before the FERC will be uncontroverted evidence that the competition that a new interstate pipeline would bring to California is sought not only by private industrial consumers of gas, but also by San Diego Gas and Electric Company, the electric and gas utility serving the San Diego metropolitan area. Exh. SD-1. San Diego no doubt recognizes that competition will pressure the CPUC and SoCal Gas to revise the discriminatory rate structure now in effect in California. The current rate scheme requires electric utilities to pay approximately 70-80 cents per

Mcf for gas transportation service by SoCal Gas, from the California border to their facilities, Exh. KR-123; Tr. 10,082-10,083 (1/25/88), even though EOR shippers pay only 22 cents to 35 cents for comparable service. Such excessive costs are, of course, passed on to those electric utilities' customers.

The FERC also will consider the inconsistent claims of SoCal Gas and PG&E (1) that certification of an interstate pipeline should be denied because the utilities allegedly can provide the necessary service at the lowest cost and therefore no customer will contract with an interstate pipeline, Exh. SG-1 at 3-4, 7-8; SG-3 at 21; PG-1 at 4-5, but (2) that if an interstate pipeline is certificated and built, it will take virtually all of the EOR market away from the utilities, shifting fixed costs of the utilities' systems that otherwise would be borne by EOR customers to non-EOR customers, and thus causing large rate increases to those customers. Exhs. SG-3; PG-1 at 59-60; PG-1J; KR-123; Tr. 11,291-292 (2/10/88). The utilities' assumption that the EOR operators will contract with an interstate pipeline even if the utilities are offering service of the same quality at a lower price is absurd on its face.

The record before the FERC shows that the benefits of Kern River's proposal far outweigh its costs. Kern River's proposed pipeline would be strategically located to deliver supplies from the Rocky Mountain area directly to California. Exhs. KR-1; KR-31. This is important for California, for producers of gas in the Rocky Mountain area and for the nation as a whole. The California Energy Commission in its Fuels Report of December 1987 projected that California's reliance on gas from the Rocky Mountains will have to increase by more than twenty times from 1986 to 2007. However, in a report prepared under contract to the CEC for the CEC's use in developing the 1987 Fuels Report, the consulting firm of Lewin and Associates, Inc., found that "the primary constraint impeding increased deliveries of natural gas from the Rocky Mountain region to California and other markets is lack of adequate transportation. There is no large scale westward running pipeline from the highly productive basins of the Rockies." Lewin went on to note that in early 1986, charges for transportation of gas on the existing indirect routes from the Rocky Mountain area to the California border were estimated at $1.30 to $2.00 per Mcf. See also Exhs. KR-31F, KR-31H. In contrast, Kern River's proposed system would be able to deliver Rocky Mountain gas to Kern County, rather than at the border, for approximately $.50 per Mcf. Exh. KR-10A.

Making Rocky Mountain gas accessible to California will reduce California's need to increase its reliance on supplies of gas from the southwestern United States. Since these supplies are also heavily relied upon by several other gas-consuming regions, including the Midwest and the North Central areas in particular, Exhs. KR-19 at 28-29, 36-37; MP-37, supplying Rocky Mountain gas to its closest and most natural market in California should increase the availability and moderate the price of gas from the Southwest to those consuming regions.

In contrast, the evidence before the FERC demonstrates that any economic impact on non-EOR consumers of gas in California if an interstate pipeline is built to serve the EOR market would be minuscule at most. First, the EOR market is primarily an undeveloped, incremental market. To the extent that a market exists today, it is for the most part not burning gas. Exhs. KR-3; KR-27 at 28, 53. Those operations that have used gas in the past have relied primarily upon gas produced locally in Kern County or upon short-term, interruptible service by the utilities. The emerging EOR demand did not exist and was not contemplated when the utilities' systems were built and therefore the EOR market never was intended to assist in paying for those systems. CPUC Decision No. 87-05-046 at 18-20 (May 29, 1987). Consequently, a new interstate pipeline to a large degree would not be competing for existing customers of the utilities, but would be striving primarily to serve customers who do not presently have adequate gas service and to whom the utilities did not expect to provide service when they invested in their facilities.

Moreover, even accepting at face value the calculations by SoCal Gas' own expert economist, Dr. Paul W. MacAvoy, of the revenues the utilities assertedly would lose if an interstate pipeline were built and were to serve every Mcf of EOR demand in Kern County, the average lost savings to residential consumers in California, assuming the same levels of consumption as in 1985, would be less than 40 cents per month. Exh. KR-27 at 57-58.

Moreover, this "lost" 40 cents per month would not be a rate increase, but at most a lost opportunity for a minimal rate decrease.

However, the record before the FERC shows that even SoCal Gas' 40-cent monthly "loss" is based on faulty assumptions. SoCal Gas' economic analysis assumed away most critical factors and ignored others. SoCal Gas assumed that the California utilities would have sufficient capacity in their existing facilities to meet the market demand the utilities projected (a demand lower than that forecast by the major oil producers) and that the utilities would offer EOR customers the same quality of service as an interstate pipeline at the same price as an interstate pipeline, yet also assumed that if an interstate pipeline were built, it would serve the entire EOR demand with nothing left over for the utilities. Exhs. SG-3; KR-27 at 21; DOJ-10 at 18. To top it off, SoCal Gas disregarded all potential benefits of a new interstate pipeline either within or outside of California. Exhs. KR-27 at 50-52; DOJ-10 at 14-18.

SoCal Gas' one-sided approach was perhaps outdone in the FERC proceeding only by the CPUC'S candid assertion that no interstate pipeline should be certificated because the existence of such competition would prevent the CPUC from imposing on EOR customers rates well above the cost of serving those customers and using the excess revenues to subsidize rates to other classes of customers. Exhs. CA-1, CA-5. Indeed, the CPUC recently argued to the U.S. Court of Appeals for the District of Columbia

Circuit that ratepayers in California already have been "irreparably harmed" by the potential interstate competition with the utilities because the pendency of Kern River's application "has already caused regulatory changes and the discounting of the LDC's long-term transportation rates" in order to meet that competition. 3/

The California utilities and the CPUC also have alleged that if Kern River built its pipeline, it would "cream-skim" away the utilities' largest non-EOR industrial customers. According to Kern River's opponents, this would further shift the fixed costs of the utilities' systems to small, captive customers. Exhs. SG-1 at 11; CA-5 at 32. Contrary to these assertions is evidence that there are virtually no industrial customers located sufficiently close to the route of Kern River's pipeline in California to make direct connections by those customers to Kern River economically feasible. Tr. 5443-44, 5479-80 (10/27/87). Even if Kern River were to transport gas for non-EOR customers, that gas would have to be delivered by Kern River to either SoCal Gas or PG&E for further transportation to those customers. Since the utilities charge a flat rate regardless of the distance gas is transported on their systems, they would lose no revenues due to Kern River's service to non-EOR customers. Tr. 10,101-10,102 (1/25/88).

3/ Petitioner's Response to Motion to Dismiss Petitions for Review, Public Utilities Commission of the State of California v. FERC, D.C. Cir. Nos. 87-1679, 88-1237 (filed May 18, 1988) at 12.

The FERC's decision also will be based in part on evidence that, despite its vehement arguments that it is a highly efficient company in a competitive market and that it can provide with its existing facilities all of the low cost, reliable, long-term transportation service that the EOR market needs, SoCal Gas has curtailed service to its electric utility customers and, on some occasions, to other large customers in three of the past four winters. Exh. KR-138; Tr. 10,633 - 10,634 (2/1/88). SoCal Gas also curtaqiled service this past summer of 1988 because of lack of capacity. Such curtailments force those customers to burn more costly and more polluting alternative fuels and to pass those additional costs on to their customers and to society as a whole.

SoCal Gas' curtailments of the 1987-88 winter and this past summer are particularly noteworthy because it was the first year during which SoCal Gas attempted to deliver substantial volumes to EOR customers while serving strong demands by its other customers. Because SoCal Gas failed to fill its underground gas storage fields during the summer season and thus came up short when the weather turned unexpectedly cold in the winter, it was forced during December 1987 and January 1988 to curtail deliveries to more than 800 of its largest sales customers because it did not have sufficient gas to meet their requirements. Tr. 10,642-643, 10,647-651 (2/1/88). The evidence indicates that SoCal Gas' choice in 1987 was to enter the winter with insufficient gas in storage to assure service during cold weather to its sales customers or to curtail transportation service to, among others, EOR customers, during the summer in order to free up capacity in its pipelines to deliver gas to its storage fields. Id. In a report issued on May 20, 1988, after an investigation into the causes and implications of SoCal Gas' 1987-88 curtailments, the Fuels Planning Subcommittee of the California Energy Commission summarized its conclusions in part: 4/

> The SoCal Gas curtailment reveals that there is relatively little excess delivery capacity at the 1987 level of gas demand in Southern California. This suggests that there may be a need for additional capacity sooner than previously thought. In particular, the curtailment raises questions about whether expected growth in demand for gas in the 1990s can be met without expanding existing facilities.

SoCal Gas' curtailments this past summer of 1988 were designed to avoid curtailments next winter. SoCal simply did not have sufficient capacity to meet its customers demands and meet its storage target to protect winter requirements. 5/

The evidence of SoCal Gas' cost structure further undercuts its claims of efficiency and competitiveness. SoCal Gas had operating and administrative costs (apart from the cost of purchasing the gas it resells) of more than $1 billion in

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4/ Fuels Planning Committee, CEC, Southern California Gas Company's 1987-1988 Curtailment, Docket No. 88-NGC-1 (May 1988) at 5.

5/ See The Public Utilities Commission of the State of California's order issued August 25, 1988 in Docket I88-08-052 concerning the curtailments by SoCal Gas this past summer.

1986. That figure was up by more than $300 million (or about 40%) over its level in 1982, despite declining sales and transportation volumes and despite generally declining rates of inflation in the economy. Exh. KR-27 at 51-52. If competition spurred even a very small reduction in SoCal Gas' costs or even just slowed the rate of increase in those costs, the economy of California and the nation as a whole would very quickly recoup the capital investment in a new interstate pipeline.

Finally, the record before FERC shows that states have more than ample means at their disposal to assist LDC's to prevent threatened "bypasses" from becoming reality. For example, in California, the CPUC began requiring open-access transportation by SoCal Gas and PG&E for their customers 2 1/2 years ago. Exh. CA-5 at 13. It has allowed the California utilities to negotiate long-term (up to 20 years) transportation rates with their customers subject to rate floors at the level of the utilities' variable operating costs. Id. at 22.

The CPUC also has divided the utilities' customers into high-priority, "core" and lower-priority (interruptible), "non-core" classes and has modified the utilities' obligation to serve the non-core class. Non-core customers who desire to switch to the core class must meet minimum advance notice requirements to enable the affected utility to realign its gas supply arrangements to reflect the new addition to its core load. Priorities of service among non-core customers are to be determined by the payment of "priority charges;" those customers to whom reliability of service is most valuable are expected to agree to pay the highest priority charges and thus ensure themselves that they are curtailed last among non-core customers. If that degree of reliability is seen as inadequate, they can opt into the core class, which will be curtailed only after all non-core loads are curtailed. CPUC Decisions No. 86-12-009, 86-12-010 (December 3, 1986).

The CPUC thus has enabled SoCal Gas and PG&E to compete with interstate pipelines like Kern River with respect to both price and, to at least some extent, quality of service. Both of the utilities claim that the CPUC's actions permit them to offer EOR customers service of equal reliability to Kern River's at a lower price. Exhs. SG-1 at 3; PG-1 at 49-50. If that is in fact the case, they have no reason to fear Kern River, for unless EOR shippers act utterly irrationally and contract for hundreds of millions of cubic feet per day of capacity in Kern River's pipeline that allegedly would provide no reliability benefits despite its supposedly higher price, Kern River never would be able to finance and build its pipeline even if FERC did certificate it.

Kern River describes this evidence in the ongoing FERC proceeding not in an effort to convince the Subcommittee of the soundness of Kern River's proposal (although we certainly believe the project's merits are compelling), but simply to illustrate that there can be, and nearly always is, more to situations where a so-called "bypass" is proposed than initially meets one's eye.

The simple, generic approaches of S. 1998 and S. 2313 to a question as complex as that of bypass cannot be appropriately or fairly applied to all situations and, therefore, cannot be consistent with the overall public interest.

This point is highlighted not only by the present situation with respect to the California market, but also by a similar case of more than 25 years ago. At that time, a proposal was made to build a new interstate pipeline into the State of California that was known as the Gulf Pacific Project. Gulf Pacific proposed to build its pipeline from the Katy Field near Houston, Texas, to the Los Angeles basin to transport gas for consumption in the electric power plants of the Los Angeles Department of Water and Power and Southern California Edison Company, two electric utilities in Southern California. Exxon (then Humble Oil) warranted a supply of more than 800,000 Mcf per day to the customers for 20 years at an established price of 18.5 cents per Mcf with fixed escalations of one cent per Mcf every four years. Amid cries of "uneconomic bypass" and dire predictions of large rate increases for residential and commercial customers of SoCal Gas, the Gulf Pacific Project was denied a certificate by the FERC's predecessor agency, the Federal Power Commission, even though the hearing examiner who tried the case recommended that a certificate be issued. It is indisputable that if Gulf Pacific had been approved and built, California's economy would have been far better off during the gas shortages and rapid oil price increases of the 1970's than it was without that pipeline. S. 1998 and S. 2313 would ignore the lessons of cases like Gulf Pacific and would ensure by statute that projects like Gulf Pacific and Kern River never would be built. Therefore, Kern River urges the Subcommittee to take no favorable action on S. 1998 or S. 2313.

1001-132.57-

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

STATEMENT OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
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ON

NATURAL GAS BYPASS

SEPTEMBER 29, 1988

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

SUMMARY OF TESTIMONY ON NATURAL GAS BYPASS

- Bypass is a highly complicated issue of local concern which is best resolved at the local level. Bypass is a matter of jurisdiction over retail sales, rather than being a matter of interstate commerce.

- Unless clear and compelling evidence indicates a significant interstate commerce implication, state authorities are the proper arbiters of such conflicts. We hold that no such evidence exists, and that our position is consistent with the recent Executive Order on federalism.

- The NARUC therefore urges Congress to enact legislation which provides that state regulators, rather than FERC, have primary jurisdiction in this area.

- Our support for such legislation should not be characterized as "anti-bypass". State regulators are not inhibitors of competition but recognize and support the increasingly competitive nature of both the wholesale and retail sectors of the natural gas marketplace.

- Bypass is of concern to NARUC members because allowing a major industrial customer to leave the system inexorably results in a reallocation of an LDC's fixed costs to remaining customers. The benefits of a bypass must therefore be weighed against any burden placed on remaining customers, and the decision must be made within the context of the local economic environment as a whole.

- Bypass can induce competition, but can also discriminate against captive customers who do not have the luxury of alternate supplies. Bypass should only be allowed if it is the interest of all concerned parties, and if alternatives have been thoroughly explored.

- The NARUC would strongly oppose any legislation providing FERC with an appellate function over state decisions. H.R. 3445 would appear to give FERC such authority over state-set cost of service rates.

- The NARUC has officially endorsed H.R. 4089 and S. 2313.

STATEMENT OF THE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
Natural Gas Bypass

The NARUC is a quasi-governmental, non-profit Association founded in 1889 comprised of the state commissions responsible for the regulation of our Nation's utilities and carriers. On the subject of this statement, natural gas bypass, the NARUC feels strongly that Congressional action is necessary to alleviate what in our view is a serious jurisdictional problem.

Introduction:

The primary focus of this testimony is that bypass is a highly complicated issue of local concern and is therefore best resolved at the local level. We therefore urge Congress to enact legislation which provides that state and local regulators, rather than the Federal Energy Regulatory Commission (FERC), have primary jurisdiction over whether or not gas users purchase their supplies from utilities or pipelines. Our position is based on a **Resolution Urging Congress to Reaffirm the Primacy of State Authority Over Transportation of Natural Gas for Consumption** which was adopted by the NARUC Executive Committee on July 23, 1987 and a **Resolution Endorsing H.R. 4089/S. 2313 (100th Congress) on Natural Gas Bypass** adopted July 28, 1988. Copies of the resolutions are attached hereto.

We would note at the outset that our support for legislation in this area should not be characterized as being "anti-bypass" or protectionist of local distribution companies (LDCs). Rather, we recognize and support the increasingly competitive nature of the natural gas marketplace. We also recognize our responsibility to encourage LDCs to become more competitive themselves, so the benefits of wholesale competition flow through to the retail level -- and this, we feel, is occurring. State regulators are not inhibitors of competition and the utility industry, by and large, has demonstrated a willingness and ability to meet today's challenges.

There is no reason, therefore, to believe that clarifying state jurisdiction over LDC transportation and bypass issues would delay or inhibit the benefits of competition from being realized at the retail level. Giving state regulators direct authority over bypass issues will, however, ensure that the transition to a more competitive marketplace occurs smoothly and equitably.

To highlight the fact that competition exists in the state-regulated environment, we would cite recent American Gas Association data which shows that 77 percent of LDCs surveyed offered unbundled transportation rates in 1987 -- a three fold increase since 1984. The study shows that transportation rates have been implemented in all regions of the country, with the largest number of rates in effect for interruptible industriales, followed by interruptible commercial customers. Many companies are also shown to have transportation rates in effect for their firm service customers and even residential customers in some cases.[1]

Discussion:

The potential for bypass results naturally from the interplay between wholesale and retail sectors of the natural gas market, when prices for so-called spot market gas are significantly lower than average LDC or pipeline system supplies. Added to this economic environment, FERC's promulgation of Order 436 and its optional expedited certificate provisions makes bypass a very real issue.

Bypass is of concern to state commissions because allowing a major industrial customer to leave the system inexorably results in a reallocation of the LDC's fixed costs to remaining customers. In a worst case scenario -- allowing unrestrained bypass -- as greater numbers of customers leave the system, and prices for those remaining increase accordingly, marginal customers would be provided with increasingly greater incentives to engage in bypass themselves. The resulting chaos would be devastating for customers not afforded the luxury of an opportunity for alternative supply, as recent analysis by the Consumer Federation of America aptly demonstrates.[2]

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[1] Gas Distribution Industry Pricing Strategies -- 1987 Update, American Gas Association, May, 1987.

Therefore, the benefits of a bypass must be weighed against any burden which may be placed upon an LDC's remaining core customers, and the decision of whether or not to allow a bypass must be made within the context of the local economic environment as a whole. While bypass should not be prohibited, because it does add competitive pressure,[3] it should be regulated so as to ensure that it provides overall benefits, rather than benefits to one customer at the expense of others.

For example, if the choice is between keeping or losing an industry important to a local economy, these increased costs may be worthwhile, in the sense of retaining needed employment opportunities, tax revenue, etc. Or, rather than allowing the bypass, there may be an opportunity to satisfy the industrial user with cost-effective LDC transportation or other considerations. However, the extent to which an LDC can provide benefits to its industrial customers without becoming discriminatory is a complex issue. The ultimate question is whether the bypass will be economic with respect to its effect on all classes of customers.

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[2] A Residential Consumer View of Bypass of Natural Gas Local Distribution Companies, Consumer Federation of America, 1988.

[3] It is interesting to note that the above-referenced AGA study indicates that, of the 30 companies surveyed which have experienced threats of bypass, each now has a transportation rate in effect.

The issues surrounding a bypass case are highly complex and situation-specific. They arise from competing interests between classes of customers at the local level -- the retail level. State regulators have the expertise and experience -- and the intimate knowledge of the utility and its local economic environment -- necessary to make a decision which provides the most appropriate balance between these competing interests.

Additionally, while natural gas has certainly become a market commodity, it none-the-less remains a basic need to much of the population. Therefore, the interests of a utility's core customers -- who are primarily non-fuel switchable and have no recourse to alternate supply -- should be given adequate weight in determining whether or not to allow a bypass. The bottom line is to ensure that all customer classes derive equal benefit from the industry's economies of scale and scope. In other words, bypass should only be allowed if it is in the interest of all concerned parties, and if alternative remedies have been faithfully explored. These remedies could most appropriately be pursued by the state commission, within the context of its authority over retail rate design.

We would also note that the issue of bypass raises important questions concerning the utility's obligation to serve. For example, it seems inequitable to allow certain customers or classes of customers to go off a system and return at will, while other customers have no such opportunity, especially if the utility is obliged to guarantee supply and/or capacity for a customer who, temporarily, may have found a cheaper deal.

This question is raised by FERC Commissioner Charles Stalon in his recent dissent in the Panhandle Eastern case (Docket No. CP86-232-000, et al.). In that case the FERC approved Panhandle Eastern's bypass of Michigan Consolidated Gas to serve National Steel Corporation. Stalon notes, "On the one hand, National Steel argues that it can lower its cost of natural gas if Panhandle is allowed to directly serve it. On the other hand, Panhandle refuses to allow MichCon to lower its contract demand with Panhandle to reflect the loss of National Steel as a customer." "In short," Stalon concluded, "the pipeline, with the help of the FERC, imposes uneconomic costs on the LDC." These costs will have to be paid by the remainder of MichCon's ratepayers.

Moreover, a serious question is raised by the likelihood of some degree of pipeline take-or-pay cost passthrough. Would a bypassing customer take its portion of any potential take-or-pay obligation with it, or would these costs too be borne by remaining customers? To balance this inequity, it may be appropriate to establish some type of penalty or reservation charge to the LDC for such activity, and this would clearly be best designed at the local level.

We hold that such analyses are best accomplished by parties who are close to the case and accountable for their findings. While we certainly have a national energy marketplace, issues such as whether a particular customer in an LDC service territory buys from the LDC or directly from a pipeline should not, as a matter of policy, be appropriately viewed as being a matter of interstate commerce and should not, therefore, fall under the exclusive jurisdiction of federal regulators, particularly ones which do not closely adhere to the concept of federalism -- a concept that this Administration has strongly endorsed,[4] but, rather dramatically, fails to practice.

Moreover, we strongly oppose any effort, either legislative or administrative, which would have the effect of providing FERC with an appellate function over state decisions. The Dowdy bill (H.R. 3445) bothers us particularly in this respect and would likely require significant amendment in order to obtain a NARUC endorsement, since it would appear to give to the FERC the authority to second guess state-approved cost of service rates. The Markey bill (H.R. 4089) appears to be the better approach.

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[4] Federalism, Executive Order 12612, 52 Fed. Reg. 41685-8, (October 30, 1987).

In our view, jurisdictional debates such as this should be viewed in the context of policy, rather than law. The sometimes Byzantine logic used by federal agencies to define as being in interstate commerce every activity over which they would like to have influence should not cloud the question of what appropriate policy should be. Such a policy, quite simply, should be that those with the best perspective on a situation should regulate in that area. While matters which are truly interstate in nature are best regulated at the federal level, whether or not a steel company in Michigan or an automobile assembly plant in Pennsylvania purchases natural gas from an LDC or a pipeline is clearly a matter of state and local concern. Unless clear and compelling evidence indicates a significant interstate commerce implication, state authorities are the proper arbiters of such conflicts.

The fact that pipelines and LDCs would eventually become "open access" transporters was certainly not foreseen by Congress in the enactment of the Natural Gas Act. Similarly, Congress could not have foreseen the jurisdictional tensions which would result as the industry evolved. But unfortunately, as a matter of practice, there is no longer a "bright line" between inter- and intra-state commerce; it has become dangerously obscured.

Congress, therefore, needs to realign the law so it is in accordance with appropriate policy. The House has recently taken action in this regard with respect to legislation (H.R. 2884) which clarifies that transportation services offered by multi-state LDCs is subject to state, rather than federal jurisdiction. The issue we are now discussing presents another worthwhile-- and necessary -- opportunity.

# # #

Resolution Urging Congress to Reaffirm the Primacy of State Authority Over Transportation of Natural Gas for Consumption

WHEREAS, Substantial changes have taken place in the regulated natural gas industry since enactment, in 1978, of the Natural Gas Policy Act (NGPA) which partially deregulated wellhead sales of natural gas; and

WHEREAS, In implementing the changes in regulatory policy mandated by the NGPA, the Federal Energy Regulatory Commission (FERC) has promulgated comprehensive new regulations which emphasize competition in the marketplace for natural gas sales and transportation service and, in turn, a decreased level of "public utility type" regulation, such as significantly relaxed review of interstate pipelines' proposals to initiate new service; and

WHEREAS, These Federal regulatory changes have a direct and substantial impact on the local distribution of natural gas and on the regulation by the States of such essentially local services; and

WHEREAS, A particularly significant instance of this impact is in the context of interstate pipeline direct transportation of natural gas to a consumer of gas that is or could be served by a State-regulated local distribution company; and

WHEREAS, The continuing ability and legal authority of the States to regulate the local provision of natural gas service is in the public interest; now, therefore, be it

RESOLVED, That the Executive Committee of the National Association of Regulatory Utility Commissions (NARUC), assembled in its Summer Committee Meeting in San Francisco, California, without opposing any particular projects, respectfully urges Congress to enact legislation which:

(1) explicitly recognizes the critical and rightful interest of States in regulating, in the public interest, the local sale and delivery of natural gas for consumption;

(2) acknowledges that natural gas services for end user consumption is a matter essentially local in nature; and

(3) confirms the preference for local distribution company service to end user markets.

Sponsored by the Committee on Gas
Adopted July 23, 1987
Reported NARUC Bulletin No. 31-1987, page 17

Resolution Endorsing H.R. 4089/S. 2313 (100th Congress) Natural Gas Bypass

WHEREAS, The NARUC believes that State regulators, charged to protect the interests of all utility customers, should have the jurisdiction to authorize or prevent utility bypass projects; now, therefore, be it

RESOLVED, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), assembled in its 1988 Summer Meeting in San Diego, California, adopts the following position on natural gas bypass:

1) The Federal Energy Regulatory Commission (FERC) should allow the States sufficient latitude to address local distribution company (LDC) bypass on an individual basis, consistent with the public interest; and

2) The NARUC endorses and urges Congress to enact legislation proposing the Natural Gas Transition Act (as originally drafted), which has been introduced in the 100th Congress as H.R. 4089 and S. 2313, respectively, to prevent the FERC from approving a bypass application if it could harm the future interests of other customers served by the affected LDC, or if the LDC is willing to provide gas transportation service under terms set by its State or local commission; and be it further

RESOLVED, That copies of this Resolution be forwarded to the Chairman, Commissioners and Secretary of the Federal Energy Regulatory Commission and to the Chairman and each member of the House Committee on Energy and Commerce and the Senate Committee on Energy and Natural Resources.

Sponsored by the Committee on Gas
Adopted July 28, 1988

NORTHWEST INDUSTRIAL GAS USERS

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Comments of Northwest Industrial Gas Users

Energy Regulation and Conservation Subcommittee

S. 1998, S. 2313 - Natural Gas Bypass Issue

September 29, 1988

Northwest Industrial Gas Users is an association of 39 industries that use natural gas in their facilities in Washington, Oregon and Idaho. The members include diverse industrial interests, including food processing, pulp and paper, wood products, aluminum, steel, chemicals, electronics and aerospace. The members vary in their use of the gas, their ability to use alternate fuels, and their proximity to the interstate pipeline system.

Although the diverse members of Northwest Industrial Gas Users may or may not be positioned to take advantage of a potential bypass, and may or may not be affected by a bypass by others, the members believe that it is essential to **maintain the option of bypass**. Therefore, Northwest Industrial Gas Users strenuously opposes S. 1998, S. 2313, and similar legislation which would effectively eliminate the bypass option.

In considering anti-bypass legislation, the issue is not whether a particular bypass proposal is in the public interest; whether a bypass will adversely affect other industrial, commercial, or residential customers remaining on the local distribution company's (LDC) system; or even whether bypasses, generally, are good or bad. These decisions will be made in proper federal and state regulatory forums. In considering anti-bypass legislation, the issue is whether eliminating the bypass **option** is in the public interest. Clearly it is not.

The importance of maintaining the "bypass option"

A Northwest industry recently purchased gas on the spot market, had it gathered, had it transported several hundred miles over interstate pipelines to where it entered the LDC's system, and then had the LDC transport the gas less than two miles to the plant. The LDC's charge to transport the gas the few thousand yards was nearly equal to the **combined** cost of the gas, gathering, and transportation over the interstate pipelines.

When an industry such as this is operating in a fiercely competitive international market and is cutting production costs every way it can, is it any wonder that it would investigate the economics of installing its own pipe to connect with the interstate pipeline a short distance away, thereby "bypassing" the LDC, to remain competitive and save jobs and production?

However, with all the regulatory hurdles and costs involved, **industrial users would not pursue a bypass it they could obtain more responsive services and prices from their LDCs.** Having the **"bypass option"** -- the threat of a potential bypass -- gives industrial gas users an important tool to help obtain these more responsive services and prices, to the long-term benefit of all consumers on the system.

The "bypass option" makes LDCs operate efficiently

The threat of a potential bypass puts pressure on LDCs to:--

- Keep general operating costs as low as possible;
- Adopt rates which do not exceed the cost-of-service for each customer class being served, eliminating cross-subsidies of other customer classes;
- Design more flexible services and rates that are responsive to customers' needs.

Improvements in operating efficiency directly benefit all gas consumers on the system. The elimination of inequitable cross-subsidies contributes to the long-term stability of the system. Furthermore, these improvements help retain and increase industrial load on the system, which further benefits all gas consumers. These improvements can result in efficient, healthy and competitive utilities.

In fact, very few bypasses have actually occurred. Simply facing the imminent threat of bypass generally causes the affected LDC to reevaluate its services and rates and reach an equitable resolution of the dispute.

The "bypass option" helps state commissions to be responsive

It is often easier for regulators to continue the status quo than to break new ground. It is also difficult to make decisions that may have short-term cost impacts, but are in the best interest of consumers over the longer-term. Without having to face the bypass option, state regulators may not take as hard a look at LDCs' operating costs, the allocation of those costs to avoid subsidies among customer classes, new LDC services or ways of packaging services, or ways to give LDCs and their shareholders some financial incentives for operating competitively and some financial risks for operating inefficiently.

Eliminating the "bypass option" will not keep industrial users on the gas system

If an industry is prevented from bypassing the LDC, this does not mean the industry will remain on the LDC system. Instead, faced with too-high rates or limited service options that do not fit their needs, industries will seek other alternatives, such as to:

-- Make a long-term capital commitment to burn a different fuel (such as converting to coal or wood waste), which means the industry is permanently off of gas and contributing no revenues to the pipeline or LDC system;

-- Install fuel-switching capability, which means the industry may periodically switch off gas and at such times contribute no revenues to the pipeline or LDC system, thereby causing greater revenue and planning instability for LDCs; or

-- Shift production to other plants in other regions (or countries), or eventually cut back production or close down plants that cannot be competitive because of high LDC rates, which means the industry is contributing less (or no) revenue to the pipeline or LDC system, and is providing fewer jobs and economic contribution to the community.

The "bypass option" is important, in addition to competition from other fuels

Simply having competition from alternate fuels is not enough to keep the pressure on LDCs to operate efficiently and adopt responsive services at cost-based rates. Not all industries can use alternate fuels. Many industries must use natural gas as part of their manufacturing process. Some use it as an integral production input, such as using gas as a feedstock in making ammonia fertilizer. For them, the bypass option may be the only tool they have, short of closing down the plant, to foster more responsive rates and services from their LDCs.

Some LDCs offer special rates only for users with demonstrated alternate fuel-burning capability. Many industries, institutional and commercial users are faced with purchasing and installing unneeded alternate fuel-burning equipment, just to qualify for the lower rate from their LDC. This is an uneconomic waste of capital that could be better spent in other areas or in creating new jobs. Such a waste could be avoided if LDC services were priced at more realistic, cost-based levels, with no cross subsidies among other customer classes.

Retaining the "bypass option" need not cause cost-shifting among customers

First and foremost, retaining the bypass option does not mean that a great number of bypasses will actually occur. Simply having the bypass option prompts the LDC and state commission to be more responsive in meeting gas users' needs while protecting the interests of all consumers on the system.

If an industry does physically bypass the LDC, there is a loss of revenue and contribution to the costs of operating the LDC system. However, the impact of this loss can be grossly overstated if the LDC's rates are not properly based on the cost of service to serve each class of customer to begin with. Where industrial customers have been subsidizing the service to other customer classes, and industrial load is lost, the impact to other customers is exaggerated because not only is the industry's fair contribution to revenues lost, but also the "subsidy" that the industrial customers were paying into the system.

In any case, these costs, if any, need not be automatically passed through to other customers. The state utility commission can review the LDC's rates and decide that the LDC's shareholders should bear some or all of the loss resulting from a bypass if the LDC did not act prudently in trying to keep the customer on the system by operating efficiently and offering market-responsive services and appropriate rates.

Furthermore, even if a customer does bypass the LDC, at least the industry is still up and running and is still using gas. This means the industry is still contributing revenues and sharing the costs of the interstate pipeline system which, in turn, are reflected in the costs passed through to the LDC and its customers. Also, the industry may still be buying some services from the LDC, such as storage or back-up service, and therefore contributing revenues and maintaining a link to the LDC. The industry has not made long-term commitments that preclude taking service from the LDC in the future, such as would be the case if the industry made the capital investment to permanently convert the plant to a different fuel.

Conclusion

Eliminating the "bypass option" will not assure a healthy utility system, stable industrial load, or lower rates for any consumers. Maintaining the "bypass option" will give consumers an effective tool in securing responsive services and equitable, cost-based rates. Maintaining the bypass option will help promote an efficient, healthy and responsive utility system. Maintaining the bypass option is clearly in the best interests of residential, commercial and industrial gas consumers alike.

WRITTEN TESTIMONY OF
MAURICE E. HALSEY, VICE PRESIDENT
NORTHERN ILLINOIS GAS COMPANY
ON S. 1998 AND S. 2313
BEFORE THE ENERGY REGULATION AND CONSERVATION SUBCOMMITTEE
SENATE ENERGY AND RESOURCES COMMITTEE
SEPTEMBER 29, 1988

My name is Maurice E. Halsey, and I am Vice President of Northern Illinois Gas Company ("NI-Gas"). NI-Gas appreciates this opportunity to present its views on two pending pieces of legislation, S. 1998 and S. 2313, and the issue they concern -- the "bypass" of local distribution companies ("LDCs") by interstate pipelines. NI-Gas believes that arbitrary and artificial promotion of bypass by the Federal Energy Regulatory Commission ("FERC") threatens residential and other high-priority end-users of natural gas with increased costs and decreased competition. The risk of bypass also is heightened by regulatory policies which unfairly tie the hands of LDCs in the competitive battle to serve end-users. Therefore, NI-Gas urges this Subcommittee promptly to report legislation which addresses the problems I will outline in this testimony.

I. DESCRIPTION OF NI-GAS

NI-Gas is an LDC serving the gas customers of northern Illinois, with the exception of Chicago. NI-Gas serves more than 1,500,000 customers, and is subject to the comprehensive jurisdiction of the Illinois Commerce Commission under the Illinois Public Utilities Act.

NI-Gas was a pioneer LDC in the provision of transportation service to its industrial end-users. NI-Gas acted quickly after FERC made transportation available to end-users to implement a parallel program. Under NI-Gas' Rider 25, over 7,000 end-users have been able to obtain firm transportation, at nondiscriminatory rates, and, in fact, almost 25% of NI-Gas' annual throughput now consists of transported gas for end-users. NI-Gas has received approval from the Illinois Commerce Commission to negotiate competitive rates with end-users who otherwise might bypass the NI-Gas system. NI-Gas also has pending before the Illinois Commerce Commission a rate proposal which would increase the service options available to end-users. NI-Gas believes that the continued expansion of service offerings continues its long tradition of service, a tradition which includes the unique distinction of maintaining service to all its industrial, commercial and residential end-users throughout the curtailments of the 1970's. This continued expansion of customer choice comes at a time when NI-Gas, through careful management of its supply options and large investments in its own storage facilities, has been able to reduce its cost of gas by 25% during the past four years without threatening the reliability of service which is central to its service obligations as a public utility.

Despite these successes, NI-Gas has been bypassed by one customer, and the threat of bypass by others continues. This threatened bypass is not the result of any unwillingness on the part of NI-Gas to ensure that end-users can obtain transportation for their own gas from the wellhead to the burner tip. Instead, NI-Gas believes that the impetus for bypass comes from federal policies which unfairly advantage pipelines in the battle to serve end-users, as well as a fundamental conflict between state and federal regulation. Only Congressional action can restore fair competition and preserve a respect for state and local concerns which is central to our system of federalism.

II. THE NATURE OF BYPASS

Bypass occurs when an end-user located in the service territory of an LDC connects its facilities directly with those of an interstate pipeline and ceases to receive service from the LDC. Bypass, therefore, reduces the contribution of end-users to the recovery of the costs of facilities installed by the LDC to serve them and others; over time, bypass inevitably will result in higher costs for the remaining customers of the LDC, particularly high-priority residential customers.

End-users bypass their LDCs to gain savings which the regulatory system makes possible. For example, in Illinois, a transportation customer avoids certain state and local taxes. Similarly, NI-Gas' transportation and sales rates include the costs of various social programs and rate design choices approved by the Illinois legislature or the Illinois Commerce Commission, which an end-user also can avoid through bypass. An end-user also may elect to bypass its LDC to avoid potential sharing in the recovery of take-or-pay costs which FERC has authorized under

Order No. 500, despite the fact that these costs were incurred, in part, for the benefit of the bypassing end-user. Bypass also may occur when an interstate pipeline offers end-users discounts on services which the pipeline does not make available to the bypassed LDC.

Bypassing customers can gain these cost savings without bearing the normally associated risks of their service elections. Moreover, end-users can pursue bypass under FERC programs secure in the knowledge that state law preserves their rights to demand service from the LDCs if the decision to bypass becomes, in a time of gas shortages or rising prices, an imprudent one.

III. THE NEED FOR CONGRESSIONAL ACTION

There is a pressing need for Congress to act on the bypass issue. Several factors demonstrate this.

First, bypass inevitably will result in higher LDC rates for the remaining, predominantly residential customers as the throughput of bypassed LDCs declines. Further, as bypass occurs, the pipelines recover in their sales rates a constant level of dollars from a shrinking pool of sales customers. This, in turn, promotes further bypass. Although FERC has declared that this is a matter strictly for the consideration of state regulators, the impact cannot be reversed simply by ignoring the causative effects of FERC policies.

Second, bypass reduces the market pressures for pipelines to offer LDCs (and the customers they serve) competitively priced services. Instead, interstate pipelines are free to offer end-users price discounts and services which they do not offer their pre-existing LDC customers. This prevents LDCs from emerging as full competitors for the continued business of end-users. It is precisely this ability of pipelines to segment their markets which led the courts to strike down earlier programs promulgated by FERC; FERC's program of full open access was adopted only after earlier discriminatory programs were rejected by the courts.

Third, bypass creates direct tension between the rate design principles of FERC and the states. For example, FERC now enables an end-user located in Illinois to avoid contributing to certain social programs which the Illinois legislature and the Illinois Commerce Commission have decided should be funded by all gas users in the State of Illinois. FERC itself often has vacillated on the issue of the proper contribution to fixed cost recovery which should be made by high load factor customers or by interruptible customers. Bypass negates the decisions of state regulators on how take-or-pay costs allocated to LDCs by FERC should be recovered at the retail level. Yet, despite this history, FERC now allows bypass if an end-user disagrees with rate design decisions of state regulators.

Fourth, bypass encourages the type of "price squeeze" condemned by the antitrust laws of the United States. On the other hand, under FERC policy, an interstate pipeline may elect to allocate recoverable costs of reforming its gas purchase contracts and settling its take-or-pay liability solely to its sales customers, even though FERC acknowledges that transportation customers also are beneficiaries of the policies which contributed to that pipeline's accumulation of take-or-pay exposure. In fact, FERC policies allow a pipeline to direct bill an LDC's customers for take-or-pay costs attributable to a decline in LDC purchase levels caused directly by that pipeline's own decision to provide transportation services to end-users, either through an LDC or through bypass. Ironically, when the LDC attempts to collect through its rates those costs created by a pipeline's voluntary actions, avoidance of those FERC-allocated costs becomes a major impetus for bypass. On the other hand, when an interstate pipeline bypasses one of its LDC sales customers, FERC does not even require that the pipeline allow its LDC customer to reduce its contract with the pipeline by a like amount. Thus, the pipeline actively can promote bypass, secure in the knowledge that it will continue to collect from its bypassed LDC customers the rates for a level of service which the LDC no longer needs precisely due to the bypass. FERC Commissioner Stalon has described succinctly the problem in a recent dissent:

> [t]he majority's position is thus one of holding LDCs should not be procedurally protected from interstate bypass competition but that interstate pipelines are procedurally protected from the logical secondary effect of their LDC bypass proposals. In short, the pipeline, with the help of the FERC, imposes uneconomic costs on the LDC. Then, in the name of competition, provides lower prices to LDC customers than the LDC can provide. This form of strategic competition is not con-

> structive and should not be approved by the FERC. It is a classic "price squeeze" antitrust offense.

Panhandle Eastern Pipe Line Co., FERC Docket Nos. CP86-232-000 et al., mimeo. at 3 (September 12, 1988) (Stalon, dissenting). Of course, when the LDC tries to compete, its rates are burdened unfairly by these pipeline charges. NI-Gas has raised these issues in a complaint which has been pending before FERC, without action, since November 1987. As a result, NI-Gas' remaining customers bear the cost of contract demand, paid to the bypassing pipeline, for volumes no longer required on the NI-Gas system.

Fifth, when FERC approves a bypass (or promotes bypass through its policies), it cannot at the same time relieve the affected LDC of its service obligations to the bypassing end-user. When FERC authorized LDCs to convert their sales contracts with interstate pipelines into transportation contracts, it decided that pipelines must be able to terminate their obligation to sell gas on demand to those LDCs; LDC customers of a pipeline cannot object to the pipeline's abandonment of its sales obligations in those cases. Yet, in the parallel area of bypass, FERC has created options for end-users, without addressing in full the economic and service consequences which must flow from those options. Thus, while in response to LDC concerns about bypass FERC has stated that, "in a competitive environment, the parties are at a risk for their own decisions," FERC actually has not applied that principle to pipelines or end-users in bypass cases.

Sixth, FERC has severely limited the ability of LDCs to compete with the bypass problem. For example, FERC apparently has decided that all of the costs of the transition to open access will be carried by the LDC sales customers of interstate pipelines. Take-or-pay costs have been addressed above. However, other categories of costs, rendered unnecessary by open access, continue to be allocated solely to sales customers. Further, if an LDC customer converts its sales service to transportation service, FERC has decided that the LDC must forfeit the protections of Section 7(b) of the Natural Gas Act. FERC also is investigating rate designs which will ration capacity in peak periods while promoting higher throughput in off-peak periods; while end-users are allowed to respond to these new economic incentives by selecting freely the types and levels of services they desire, FERC has not allowed LDCs to adjust their contracts to reflect implementation of these goals.

Seventh, even if open access, on the terms and conditions dictated by FERC and without the input of state regulators, should be developed uniformly throughout the country, FERC's promotion of bypass is premature. At this time, FERC still has not issued a final rule in its Order No. 500 proceeding, almost sixteen months after Order No. 436 was remanded by the courts. FERC still is working on major new initiatives dealing with rate design, brokering, and gas inventory charges. It is incongruous that FERC will penalize LDCs for not complying quickly with FERC's agenda, when FERC itself has such problems completing action on a timely basis. Further, even once a uniform policy is adopted, a transition period must be allowed for LDCs to formulate their responses and seek state regulatory approval thereof. For example, on August 22, 1988, NI-Gas filed tariff sheets which expand the services available to its customers. Under Illinois procedures, these tariff sheets are not likely to become effective until mid-1989. Because these tariff sheets include standby sales services, further changes may be required to be filed if FERC allows NI-Gas' pipeline suppliers to institute Gas Inventory Charges.

Eighth, Congress must recognize that the bypass issue raises very important and difficult issues of Federalism. Bypass is based on the assumption that state regulators and legislators can differ with the policy decisions of the FERC only at their peril. However, continued experimentation in the fifty state laboratories is essential to the continued growth of this country and the appropriate recognition of state and local interests.

Congress also must proceed because FERC has already determined that the issues addressed above will not be considered by it when it considers bypass applications. In some cases, FERC's regulations allow bypass to occur without any prior FERC approval. In other cases, under the Optional Expedited Certificate procedures, FERC has stated the issues raised herein would not be considered. Even in traditional certificate cases, FERC has held that the sole controlling issue in a bypass case is the desire of the end-user and that the difficult policy and factual issues and concerns of other affected parties which I have discussed do not even warrant a hearing or other consideration by FERC. Thus, Congressional action is required by FERC's inaction.

IV. THE GOALS OF BYPASS LEGISLATION

Any bypass legislation should achieve two essential goals. First, state regulators should retain effective control over the services offered by LDCs and the rates charged for those services. FERC should not be allowed, by approving bypass applications, to pass judgment on state-established rates. However, it is equally important that LDCs be required to provide transportation services to industrial end-users. While NI-Gas opposes the uneconomic bypass promoted by FERC, it does not believe that it or any other LDC should be able to force end-users to purchase sales rather than transportation service. NI-Gas believes, therefore, that any bypass legislation should preserve the availability to end-users of transportation from the wellhead to the burner tip.

V. CONCLUSION

Congress should encourage the continued availability to industrial users of transportation from the wellhead to the burner tip. However, energy policy also must recognize the jurisdiction of state regulators and the service obligations of LDCs. Unfortunately, present regulations promote uneconomic bypass, without consideration of the impacts on all consumers or the anticompetitive impacts of bypass' tacit approval of pipeline price squeezes. Bypass legislation, therefore, should preserve the jurisdiction of state regulators, secure in the knowledge that market forces will be reflected in the choices of state regulators. As long as end-users can elect where to locate new plants and plant expansions, decide whether to install alternate fuel capability, and participate fully in state regulatory proceedings, there can be no justification for the continued preemption of state regulators' consideration of and jurisdiction over the difficult issues raised by bypass. FERC must not be permitted to ignore legitimate state and local concerns and authority.

Statement by

Pacific Gas and Electric Company

for submission to

Hearing Record

Subcommittee on Energy Regulation and Conservation

Senate Committee on Energy and Natural Resources

September 29, 1988

STATEMENT BY PACIFIC GAS AND ELECTRIC COMPANY
SENATE SUBCOMMITTEE ON ENERGY REGULATION & CONSERVATION
COMMITTEE ON ENERGY & NATURAL RESOURCES

Pacific Gas and Electric Company (PG&E) appreciates the opportunity to comment to the committee on the issue of interstate pipeline bypass of local distribution companies (LDCs). Bypass is a serious problem for LDCs, and those natural gas consumers relying on them for economical and reliable gas service. This is particularly true for PG&E.

The enhanced oil recovery (EOR) market in Kern County, California is the primary target of three proposed pipeline projects to bypass existing LDC transmission facilities serving Kern County: the Mojave, Kern River and Wyoming-California (WyCal) pipeline projects. A substantial portion of the Kern County EOR market is served by PG&E.

Bypass is frequently touted under the guise of increasing competition for the LDC. However, at the heart of the bypass issue is the question of the appropriate roles of state public utility commissions (PUCs) and the Federal Energy Regulatory Commission (FERC) over end-user natural gas rates and services. This is an issue that PG&E believes requires Congressional resolution.

In summary, PG&E believes that bypass should not be authorized where LDCs provide, or can provide, service to the end-user on a competitive basis. In particular, bypass should not be authorized where its primary and overriding purpose is simply to substitute FERC regulation for state PUC regulation -- that is, regulatory forum shopping.

PG&E has the demonstrated ability and willingness to competitively serve growing markets, such as the EOR market. Declines in gas demand by existing markets, similar to the experience in other markets across the U.S., have created excess capacity on PG&E's gas transmission system to serve the present and growing EOR market.

In 1987, PG&E's total gas deliveries were 803 billion cubic feet. This volume included 126 billion cubic feet of customer-owned gas transported under PG&E's nondiscriminatory transportation program. Over 31 billion cubic feet was destined for the EOR market, including gas which PG&E transported for EOR producers in Southern California Gas Company's (SoCal Gas') service area under an interutility transport agreement designed to provide the most economical delivery of gas to EOR producers in Kern County.

Working jointly, PG&E and SoCal Gas have the ability to fully serve the growing EOR and related cogeneration markets and, if necessary, to incrementally expand facilities on a cost effective basis tailored to those markets as they develop. FERC regulated pipelines paralleling the existing intrastate pipelines are not needed to meet EOR capacity requirements.

Increasing competition for LDCs, whose rates are established by state PUCs, is often advertised as a benefit of bypass. Fundamentally, however, the competition is not with the services offered by the LDC, such as gas deliverability or the availability of nondiscriminatory transportation, but with the agency with jurisdiction over the services being provided.

PG&E is a competitor; we are not afraid to compete in the provision of economical services. We compete daily with alternate fuel suppliers and other gas suppliers for sales to large commercial and industrial gas consumers. We offer nondiscriminatory transportation services under CPUC-approved tariffs. We have competitive rates and have negotiated very competitive transportation agreements with large volume gas consumers, including EOR producers and EOR related cogenerators.

PG&E is authorized by the California Public Utilities Commission (CPUC) to negotiate individual contracts with terms and conditions tailored to each EOR project's specific requirements and economics. Our continued success is demonstrated by three major new long-term transportation contracts for EOR related cogeneration projects which we have recently signed.

PG&E's willingness to compete is not driven by the threat of pipeline bypass. Instead, it is driven by the knowledge that competitively serving existing customers and incremental growth markets, such as the EOR market, provides revenues which reduce the fixed costs that otherwise will be borne by residential and commercial consumers.

Our conservative estimate is that through the year 2000, bypass by any of the proposed pipelines to Kern County would cost our ratepayers well over $200 million. This amount does not include revenues that could be lost due to a siphoning of PG&E's industrial customers within easy reach of the bypassing pipelines, since they would essentially parallel PG&E's existing transmission lines already serving them and the EOR market.

The impact is even greater for the nation as a whole. In its recent report entitled "A Residential Consumer View Of Bypass Of Natural Gas Local Distribution Companies" the Consumer Federation of America estimated that the annual cost of bypass to U.S. residential consumers could be about $2 billion. This is a high price indeed to pay for customized jurisdictional shopping, particularly when it is the state PUC, not the FERC, which has the regulatory burden for the recovery of the costs resulting from FERC's approved bypass.

A bypass proposal, and all its economic consequences, should not be a matter decided by regulatory competition fostered by regulatory forum shopping. PG&E urges Congress to consider the adverse consequences of such a public policy and to enact legislation recognizing the proper role that state PUCs, the

FERC, and the competitive services offered by LDC, such as nondiscriminatory transportation, should have in assessing bypass issues.

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TESTIMONY OF

SERVICE EMPLOYEES INTERNATIONAL UNION, AFL-CIO, CLC

BEFORE

THE HONORABLE WYCHE FOWLER

PRESIDING

ENERGY REGULATION & CONSERVATION SUBCOMMITTEE

ON

THE NATURAL GAS CONSUMER PROTECTION ACT OF 1988

SEPTEMBER 29, 1988

SUBMITTED BY:

SERVICE EMPLOYEES INTERNATIONAL UNION
PUBLIC POLICY DEPARTMENT

The Service Employees International Union (SEIU) welcomes the opportunity to submit written testimony in support of the S.1998 The Natural Gas Consumer Protection Act. This bill addresses the authority of interstate natural gas pipeline companies to "bypass" local gas distributing companies, providing service directly to certain large industrial "end-users".

SEIU represents over 850,000 workers in both the public and private sector and has close to 10,000 members employed in the gas industry, primarily in gas distribution. SEIU actively joins with other labor unions, consumer groups, commercial businesses and local gas distribution companies (LDC's) in calling for swift action to deal with the burgeoning problem of natural gas bypass. The action called for is the coordination of the authority of the Federal Energy Regulatory Commission (FERC) and that of state and local regulators making decisions on bypass proposals.

To date, the FERC's development of modern natural gas policy has proceeded on a haphazard, case-by-case course. This piecemeal approach combined with several court reversals of FERC rulemaking has created a situation of "regulatory chaos". It is under this cloud, that certain interstate pipeline companies, with FERC approval, have sought to capture large industrial customers currently served by local distribution companies.

In essence, FERC has given interstate pipelines unfettered license to bypass LDC's and circumvent the authority of state public utility commissions. FERC maintains that the determining criteria as to whether bypass permission should be granted is whether the large industrial end-user can be directly served by the pipeline at a lower cost. This criteria is totally inadequate, since it prevents input from and consideration of parties directly and dramatically effected by the bypass decisions--residential consumers, workers, other commercial and small industrial users, and the LDC's.

SEIU believes that the bypass decisions are best left to officials on the local level. Local or state utility commissions are better able to make a fair assessment of the costs and benefits of a bypass proposal. Since it is FERC's stated policy not to yield to state public utility commissions, it is necessary to pass legislation to ensure that bypasses are dealt with where they make their most significant impact-- on the local level.

SEIU considers bypass an important issue because it effects local natural gas rates, workers' jobs, neighborhood health and safety, and the future of the local distribution company network.

Effect On Residential and Small Business Customers

It is important to understand that states grant natural gas distribution companies the exclusive right to provide retial service in a defined geographic area. In exchange for this monopoly set up, LDC's have a mandated responsibility to serve the needs of all present and future customers in that service area. In order to do this

LCD's invest in integrated distribution and transportation systems designed to serve all customers safely and efficiently regardless of the customer's size or location.

The LDC's "obligation to serve" is quite distinct from the relationship between the interstate pipeline and a particular customer. The interstate pipeline is obligated to serve only if the pipeline chooses to enter into a contract to provide natural gas service.

Congress must realize, as FERC has failed to do, that the states play an essential role in regulating natural gas rates. FERC is attempting to undermine the ability of the state commissions to structure fair and equitable rates for gas consumers within their state. As a consequence, residential and small commercial users will be seriously hurt.

It is not surprising that residential customers and small businesses will be the hardest hit by the cost-shifting that results from bypassing. When large volume industrial users leave the LDC system and tie directly into an interstate pipeline, it causes the shifting of fixed costs onto the remaining customers.

For example, in the Detroit, Michigan area, the local distribution company, Michigan Consolidated Gas Co., was recently bypassed by an arrangement made between Panhandle Gas Pipeline and National Steel Corp.- Great Lakes Division. This bypass has resulted in significant losses in revenue for MichCon and residential customers are scheduled to see their rates rise this fall. SEIU is directly involved since it represents over 1,000 workers who are employed by MichCon and who are also residential customers facing the prospects of higher gas bills.

Bypass is not only effecting our members and consumers in Michigan. To date there have been at least 27 separate bypass proposals made before FERC, effecting 12 states. If bypasses are permitted in these areas, the rates to remaining customers will be forced up. As rates go up, LCD's become even more vulnerable to further bypass attempts. Ultimately, all the large volume industrial users who can possibly tie into the interstate pipelines will do so, leaving consumers, commercial customers and smaller industrial users to foot a very large bill.

Impact On Gas Utility Employment

Higher rates for natural gas will also have an impact on employment in the gas industry. Rampant bypass could certainly effect current jobs, as local distributing companies are forced to streamline operations in attempts to keep rates competitive in order to prevent further departures from their network.

Even more likely is the dampening effect higher rates would have on the creation of future jobs in the gas industry. If local natural gas rates are higher than other competitive energy rates, such as oil and electricity, it will be not be the energy resource of choice. For instance, a developer deciding whether to incur the cost of running natural gas lines into a new development will decide against it if natural gas rates are high and seen as a liability to housing sales.

Similarly, companies with the ability to switch from natural gas to oil may decide to interrupt their gas use. Also, new industries may choose to utilize different energy sources. Both of these situations result in curtailed future demand for natural gas. Growth and expansion in the gas industry is important to SEIU efforts to improve our members standard of living and better the quality of their lives.

Bypass, on the other hand, does not create jobs. Pipeline companies only employ a certain number of personnel to cover a particular geographic region and the addition of a direct serve industrial customer rarely effect overall employment.

Health And Safety Concerns

One of the most pressing concerns regarding the establishment of bypass arrangements is the fact that once an industrial customer connects directly with an interstate pipeline, the bypassed local distributing company is no longer involved. This means the LCD no longer services the large industrial plant's operation. State regulators require that LCD's perform periodic inspections of the system of all their large industrial customers, testing pressure gauges and monitoring meters to make sure everything is operating safely.

This protection will be dropped since pipelines are under no obligation to check lines. The interstate pipelines do not maintain crews to take over the responsibility of safety monitoring from the LCD's. Many times, as is the case with the Pan Handle bypass of MichCon, the new pipeline connection passes right through residential areas.

At present, it is unclear exactly what would happen in the case of an emergency such as a pipe leak, faulty pressure control gauge or explosion.

It is doubtful whether the pipeline company would be able to respond in time, if at all since they do not maintain crews. Most likely it would be the LCD emergency response personnel, our SEIU members, who would be called into action; conceivably risking their lives to correct a problem they have no responsibility for in the first place. The members of the Service Employees International Union and their families do not find such an arrangement prudent nor workable.

Conclusions

The benefits of natural gas bypass arrangements, namely reduced energy costs to a particular industrial plant, are not worth all the costs and risks associated with this practice. Decisions regarding bypass can not be made without considering the impact on the communities; the consumers, the workers, and the small businesses. SEIU will continue to work for legislation which curbs FERC unilateral power and shifts the decision-making authority on bypass matters to where it belongs-- the local level.

SOUTHERN CALIFORNIA gas COMPANY

1150 CONNECTICUT AVENUE, N. W., SUITE 717
WASHINGTON, D. C. 20036 • (202) 822-3707

RUFUS W. McKINNEY
Vice President

October 5, 1988

The Honorable Howard Metzenbaum
Chairman
Subcommittee on Energy Regulation & Conservation
SH-212 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Metzenbaum:

Enclosed is the statement of the Southern California Gas Company in response to the hearing of September 29 on S. 1998 and S. 2313 regarding bypass of local distribution companies. We appreciate your holding the hearing on this subject. We believe the hearing testimony and the involvement of so many members clearly demonstrate that Congressional action is needed and that bypass is recognized as a significant issue of national consequence.

Sincerely,

Rufus W. McKinney

Enclosure

GHF/rem

Abstract of Statement of
Southern California Gas Company
Subcommittee on Energy Regulation
and Conservation, Committee on Energy
and Natural Resources
U. S. Senate

SoCalGas strongly supports enactment of Federal legislation that would clarify the role and responsibilities of Federal and state governments in determining the merits of bypass and we urge the committee to consider S.2313 an appropriate legislative means to achieving this objective.

Bypass involves the direct hookup by an interstate pipeline of a gas customer served by a local distributor. Federal legislation is needed because:

1. Bypass has large adverse national economic impacts, estimated by the Consumer Federation of America at over $2 billion annually;
2. The Federal Energy Regulatory Commission has ignored these impacts and has failed to adequately discharge its public interest responsibilities;
3. State and local governments are the logical bodies for weighing and resolving conflicting local interests; and
4. Local gas distributors have aggressively competed for industrial customer business and will not be shielded from the forces of competition if Federal bypass legislation is enacted.

Statement of
Southern California Gas Company
Senate Subcommittee on Energy Regulation and Conservation

The "bypass" of a local gas distribution company (LDC) involves the direct hookup by an interstate pipeline of a gas customer of the LDC. Southern California Gas Company (SoCalGas) welcomes the opportunity to comment on the question of whether Federal legislation is needed to address the jurisdictional issue of who should regulate natural gas services to end-users in utility bypass cases.

POSITION

SoCalGas, one of numerous local distributors having been bypassed or with bypass cases pending, strongly supports enactment of legislation, such as S. 2313, that would clarify the role and responsibilities of Federal and state governments in determining the merits of bypass.

Because the FERC's new procedure for considering bypass applications largely ignores the concerns of state utility commissions and the local impacts of utility bypass, Congressional action is now urgently needed to ensure that small gas consumers, the economy, and the environment are not harmed by inappropriate utility bypass.

Congress can provide this protection while simultaneously supporting the wellhead competition goals of the Natural Gas Policy Act of 1978. It can achieve this by passing legislation that allows utility bypass only where:

1) The state or local utilities commission believes that the bypass would not prejudice the present or future interests of all of the customers of the local utility, and

2) The local utility is not willing to provide transportation service to the bypass customer on terms and conditions accepted by the state or local utility commission.

These limitations on bypass approvals would not prohibit utility bypass. They would simply ensure that the state utilities commissions would have a proper role in determining whether or not the impacts from utility bypass would be acceptable within their jurisdictions.

A NATIONAL PUBLIC POLICY ISSUE

When a bypass occurs, costs are invariably shifted from the customer who bypasses the local distributor to residential, commercial and small industrial customers remaining on the system. As a result, rates for these remaining customers rise. The Consumer Federation of America has estimated that the potential future increases in residential rates from bypass nationwide have a present value of over $2 billion. For SoCalGas' customers alone, the potential future increases have a present value of over $330 million.

Proponents of bypass legislation argue that legislation is needed to clarify jurisdictional responsibilities and to restore balance in the consideration of local public interest impacts of bypass. Opponents argue that the threat of bypass is necessary to force local distribution companies (LDCs) to offer competitive rates and services to large industrial customers. Opponents of legislation also state that the actual incident of bypass is too insignificant to warrant Federal legislation. Both proponents and opponents of Federal legislation agree, however, that the issue is complex and should be addressed on a case-by-case basis.

SoCalGas' reason for urging Federal bypass legislation directly relates to the arguments made by both the proponents and opponents of bypass legislation. Specifically, we believe that 1) contrary to the opponents' position, bypass has large adverse national economic impacts, 2) legislation is needed to protect the interests of all consumers, 3) state and local governments are the logical bodies for weighing and resolving conflicting local interests, and 4) bypass legislation does not mean LDCs will be shielded from the forces of competition.

Although there may be a short term economic benefit to the bypass customer, this often results in costs being shifted to remaining utility customers. In addition, bypass often results in net harm to the local and national economy through a reduction in the efficiency of the distribution system. The long-term effects of bypass are a duplication of pipeline capacity, which reduces the efficiency of the economy, needless environmental damage, and higher costs for everyone. Bypass is therefore an important public policy issue, fully deserving of Congressional action to ensure that the broad public interest is served.

Historically, the Federal Energy Regulatory Commission (FERC) has favored LDC service to industrial customers in cases in which an interstate pipeline has attempted to bypass an LDC to serve directly an industrial customer. Recently, however, in its zeal to encourage competition, FERC has abandoned this policy. Of even greater concern than this move to usurp state and local authority is the FERC's abandonment of any consideration of the impacts of bypass beyond the benefits provided the customer seeking the bypass. Indeed, FERC's recent "on behalf of" decisions have virtually eliminated even FERC oversight of bypass. Under these rulings, a pipeline or end-user can bypass a local gas distributor without FERC's review of the merits of the bypass and without providing an opportunity for states, local distributors, or other interested parties to challenge the bypass.

FERC casually dismisses the impacts of bypass on the LDC's other customers as a problem the affected state commissions must resolve. However, these problems do not go away simply because FERC chooses to ignore them, nor does FERC provide states any opportunity to weigh the pros and cons of bypass on the broad public interests when bypass is presented to the states as a fait accompli. Indeed, no one has proposed that local gas distribution activities be deregulated, nor that industrial end-users be denied an opportunity to argue their case before the appropriate state commissions. Given the interrelationship of local gas rates, SoCalGas fails to see the logic of splitting the jurisdiction of these rates and services between the states and the Federal government based solely on whether a customer may choose to bypass an LDC.

A HISTORY OF INNOVATION

Opponents of bypass legislation seem to believe that without the threat of bypass, LDCs will not provide competitive rates and services. SoCalGas contends, and the record clearly shows, however, that many local distribution companies and their state commissions have been keeping pace with (and on occasion have been in front of) the FERC on bringing competitive forces to play in the natural gas market. SoCalGas has been an active participant in these developments.

For example, early in 1983, SoCalGas initiated a gas rate indexing program for electric utilities. This program effectively guaranteed that natural gas rates would never rise above the cost of an equivalent amount of energy from alternate fuels. In 1984, SoCalGas extended this program to other large gas users. SoCalGas was active in pioneering the gas spot market in mid-1985, immediately after FERC abolished pipeline minimum bills. We have continued our spot market involvement, and last year purchased 290 Bcf -- nearly 30% of our sendout -- on the spot market. We sought California Public Utility Commission (CPUC) authority to commence transportation service early in 1983. In late 1985, the CPUC granted us the authority to establish a sizable transportation program, thereby unbundling our services and giving our larger customers the ability to make their own gas purchase arrangements. This program has been popular with our large power plant and industrial customers, for whom we transported 223 Bcf in 1987.

On another front, SoCalGas has initiated and filed a proposal for assigning access priority to pipeline capacity on our own system and for assigning similar access priority to our firm service rights on our interstate suppliers' systems. This proposal was filed two months in advance of FERC's own Notice of Proposed Rulemaking on capacity brokering. SoCalGas has recently proposed and is currently seeking approval for other innovative programs to address the needs of large customers.

Our historic record on competition is equally strong. For years, SoCalGas and many other LDCs across the nation have provided vigorous inter-fuel price competition for oil, electricity and other natural gas alternates, which has been of great benefit to consumers and to gas producers. On May 1, SoCalGas and the CPUC took a further step toward ensuring competitive gas rates by establishing a new rate structure, which seeks to base gas sales and transmission rates to each of our customer classes on the cost of serving it. In 1987 SoCalGas' throughput was more than one trillion cubic feet of natural gas, the highest since 1972, demonstrating the competitiveness of utility service. This level of throughput could not have occurred in the absence of creative local regulation and distribution management. Our industrial customers have benefited most from this competition. Between 1983 and 1986, SoCalGas' average gas rate declined by 23 percent while our average rate to industrial customers over this same period declined by 30 percent.

CALLS FOR ACTION

Local gas distribution companies, consumers, and environmentalists are not the only parties who recognize that the FERC has reversed its long held position against utility bypass, and that federal legislation is needed to remedy this situation:

- In an opinion concerning FERC's Order No. 436, Appellate Court Judge Mikva observed: "By facilitating efforts to bypass LDCs, the Commission...has prevented the state commissions from protecting affordable rates for local consumers... I believe the Commission, and now this court, too quickly dismissed these important concerns about intrusion into the states' sphere of authority... I believe also that the majority fails utterly to hold the Commission to its legal requirement of providing a reasoned explanation for its departure from its previous policy against bypass."
- In a recent court decision regarding the bypass of Michigan Consolidated Gas Company, Judge Bell observed: "The Court is not oblivious to the substantial local interests at stake. In holding the MPSC may not exercise the asserted regulatory authority to protect those interests, the Court has merely given effect to the regulatory scheme established by Congress in accordance with its interest... If these procedures are deemed to offer inadequate protection, then it is for Congress to fashion an appropriate remedy."
- In a statement on the same bypass case, one of the FERC's own Commissioners, Charles Stalon, expressed his opposition to FERC's bypass policy: "The economic effect of the majority's decision, with respect to interstate pipeline by-pass proposals, is to encourage additional customers to flee LDC systems as per unit costs are driven up because of lost load and FERC-enforced contract demand payments even though the capacity is no longer needed because of by-pass. Stated in another way, the majority's by-pass ruling places interstate pipelines in a no-lose situation and LDCs in a no-win situation. Clearly, this asymmetric distribution of benefits and losses cannot be claimed to be the logical outcome of constructive competition between interstate pipelines and LDCs."

CONCLUSION

The actions we have described above, as well as similar actions taken by other local distribution companies throughout the U.S., are not those of an industry trying to shield itself from competition or of an industry that refuses to compete. Jurisdictional arguments aside, market realities would not allow gas distributors to withdraw from competition even if we wished to do so.

Each case of local utility bypass by interstate pipelines will have different consumer, economic, environmental, and local utility impacts. The net outcome of each bypass case -- beneficial or detrimental -- will be felt locally for the most part. It is therefore appropriate that the agencies that have responsibility over local gas distribution -- the state public utilities commissions -- have concurrent jurisdiction in utility bypass cases.

The provisions of S. 2313 would not prohibit utility bypass. They would simply ensure that state utilities commissions would have a proper role in determining whether or not the impacts from utility bypass would be acceptable within their jurisdictions. In addition, such limitations would encourage local utilities to provide transportation service to their customers, which is a primary objective of current FERC policy. Local transportation service, in turn, would stimulate the direct purchase of gas by end-users, thus expanding the wellhead market for natural gas and promoting FERC's other objectives of open-access gas transportation and service unbundling on interstate pipelines.

SoCalGas strongly supports S. 2313, which would provide an effective means for ensuring a thorough and fair review of distribution utility bypass cases.

Southern California Gas Company
October 1988

Robert H Campbell
President

JS

SUN

Sun Refining and
Marketing Company
Ten Penn Center
1801 Market Street
Philadelphia PA 19103-1699

September 22, 1988

The Honorable J. Bennett Johnston
U. S. Senate
Washington, D. C. 20510

Dear Senator Johnston:

It has come to our attention that the Congress is considering legislation that would prohibit bypass of the local distribution company (LDC). Sun Refining and Marketing Company is opposed to any legislation that prohibits bypass of the LDC, such as S.2313 and S.1998.

Petroleum refining is a highly competitive industry and minimizing operating costs is essential. With the exception of raw material costs, fuel costs are by a large margin the largest single operating expense. We have been diligently working at minimizing these energy costs by spending significant capital to conserve energy, utilizing alternate fuels where appropriate and purchasing natural gas for transportation by interstate pipelines under the FERC open transportation regulations for delivery either by direct hookup to the interstate pipeline or use of the LDC.

S.2313 and S.1998 will remove an essential incentive for the LDC to be responsive to the Users' needs and to keep costs in line with the service rendered. Prohibiting bypass of the LDC places restrictions on a competitive market. For example, the LDC charged 30¢/DTH to transport the gas about one mile from the interstate pipeline connection and one mile back to a plant connection in the same vicinity as the interconnect, while the interstate pipeline charged 45¢/DTH to transport the gas about 2,000 miles. In some cases, the interstate pipeline connection is in the refinery, totally eliminating the need for an LDC. In other cases, an LDC is used since capital would be required to make the connection to the interstate pipeline. If the LDC charges are in line with the service rendered, expenditure of capital, in order to bypass, will not be justified.

The LDCs have argued that bypass will increase cost to residential customers, due to reduced thruput, but they fail to realize that if the delivered cost of natural gas is not economical, alternate fuels will be used and they will still lose the capacity. They also face the potential loss of increased use. In evaluating the installation of new processing facilities, energy costs are a factor, and if a particular refinery has high costs, the new unit may not be built or might be built in another location with the associated gain in construction and operating jobs lost to the original area.

We wanted to make you aware of our opposition to legislation prohibiting bypass of LDCs and request your support. We believe that bypass is a legitimate form of competition, and that the FERC has given careful consideration to this issue.

Yours truly,

Robert H Campbell

Robert H. Campbell
President

REW:MEB

J Donald Annett
Vice President

Texaco USA

1050 17th Street NW
Suite 500
Washington DC 20036

September 28, 1988

Honorable Howard M. Metzenbaum
Chairman
Subcommittee on Energy Regulation and
 Conservation
Committee on Energy and Natural Resources
United States Senate
210 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Metzenbaum:

Texaco would like to take this opportunity to provide to the Subcommittee our comments on S.1998 and S.2313, which are the subjects of a hearing on September 29, 1988. As a major producer, marketer, purchaser and consumer of natural gas, our company is very much interested in maintaining competitive entry into all natural gas markets.

Attached is a set of written comments on behalf of Texaco Inc. We respectfully request that it be included as part of the official record for the September 29th hearing.

Sincerely,

J Donald Annett

JCP:cws
Attachment

cc: Senate Energy Committee (w/attachment)

DENIAL OF COMPETITIVE SOURCING OF ENERGY THROUGH ANTI-BYPASS LEGISLATION: EFFECTS ON AMERICAN INDUSTRIAL COMPETITIVENESS

COMMENTS

OF

TEXACO INC.

ON

SENATE BILLS S.1998 AND S.2313

SUBMITTED TO THE

SUBCOMMITTEE ON ENERGY REGULATION AND CONSERVATION

COMMITTEE ON ENERGY AND NATURAL RESOURCES

UNITED STATES SENATE

SEPTEMBER 29, 1988

As a major producer, marketer, purchaser and consumer of natural gas, Texaco Inc. ("Texaco") opposes Senate bill S.1998 and S.2313 ("Senate Bills"), the so-called anti-bypass legislation, on grounds that they are economically unsound, will tend to enhance the monopoly power of local distribution companies ("LDC's"), and will otherwise undermine major efforts which have been recently taken by the Federal Energy Regulatory Commission to promote open and efficient competition in the distribution of natural gas throughout the United States. The Senate Bills are apparently intended to protect particular consumer groups or local geographical areas; however, closer examination reveals that the proposals will encourage anticompetitive practices by local distribution companies and will establish or perpetuate burnertip prices for natural gas which bear no reasonable relationship to underlying production and transportation costs. When uncompetitive, artificially high gas prices persuade industrial users to seek elsewhere for low cost energy, residential consumers of gas will have to pay the full costs of underutilized gas pipeline and distribution systems. This result will be equally harmful to the vast majority of ordinary American consumers and to American industry in general.

The claims by local distribution companies about the threat of being "bypassed" by interstate pipelines are simplistic and misleading. LDC's are merely being confronted with efforts by American industry to pursue what has been accurately termed "competitive sourcing" for energy.

LDC's should be, and in most cases are, in the best position to compete with producers and interstate pipelines in supplying natural gas to industrial firms and end-users. An LDC's pipeline system is already in the ground, and it has an ongoing business relationship with the industrial end-user. The fact that a natural gas producer, marketer, or interstate pipeline could successfully compete with an LDC for gas sales contracts with an industrial end-user, when in most instances that would require construction of new laterals and other facilities requiring substantial investment, indicates that the LDC is not competitive in the pricing structure it offers through its current monopolistic position. There is simply no reason that an LDC should not be able to compete with other gas suppliers unless it is inefficient, overstaffed, suffering from poor management, or is otherwise subsidizing other end-users. LDC's are not being victimized by pipelines, or by producers, marketers, or their own customers. The simple fact is, the natural gas industry as a whole is responding to irresistible demands for change, and LDC's will have to do likewise.

Enactment of the Senate Bills will insulate LDC's, at least in the short-term, from the competitive realities of today's economy. The end result will be to reduce or eliminate any incentive on the part of LDC's to operate efficiently and minimize controllable costs. This can only have the effect of undermining the ability of industries located in certain geographical areas to compete with other industries both in the United States and throughout the world.

Despite the complaints of LDC's, failure to enact anti-bypass legislation will not precipitate construction of hundreds of duplicate laterals and pipeline systems. To the contrary, the absence of a federal ban on bypass will force LDC's to compete for business and to sharpen their business skills in very real economic terms. By allowing American industry to capitalize on the promises of open access competition in emerging nationwide natural gas markets, LDC's and state regulatory agencies will be persuaded to modernize their ratemaking functions in order to provide LDC's with the regulatory framework in which to compete with natural gas producers, marketers, and interstate pipelines. Perhaps most importantly, the mere ability of a natural gas producer, marketer or interstate pipeline to be able to compete against LDC's will force them to pursue energy markets through competitive and efficient operations without economic distortion. Such policies can only result in lower energy costs across the board.

Many policymakers, even in consuming states, are coming to an awareness of these new realities. For example, Mr. Alan Schriber with the Ohio Public Utilities Commission recently testified before a congressional subcommittee that the State of Ohio, in apparent recognition of the newly emerging competitive environment in the natural gas industry, provides Ohio local distribution companies with the flexibility to charge sales and transportation rates to end-users at levels which are necessary to meet competition. Such a regulatory framework will allow LDC's to compete with producers and interstate pipeline companies in maintaining supply contracts with industrial end-users while at the same time allowing American industry to benefit from the lowest priced available energy sources.

Recent developments in the enhanced oil recovery market in the state of California provide a classic illustration of what can happen to LDC's and their state ratemaking structure if the threat of competition is introduced into the marketplace. Until very recently, the two major LDC's in California allowed virtually no intrastate transportation. Industrial purchased gas rates were established through a regulatory scheme that provided substantial subsidies to other end-users. Moreover, the rates charged by the major LDC's to EOR customers were only marginally competitive, indeed sometimes totally uncompetitive, with alternative fuel oils.

After several interstate pipelines filed applications with the Federal Energy Regulatory Commission to construct interstate pipelines to serve the California EOR markets, both the LDC's and the California Public Utilities Commission reacted sharply, immediately initiating a number of positive changes to enable the LDC's in California to meet the competition injected by competing alternative gas suppliers. Fundamental changes were made in the CPUC's regulatory philosophy in order to make transportation available to EOR producers in California. Thereafter, new tariffs and related orders were issued which had the effect of making transportation rates offered by the California LDC's to EOR producers more competitive with the rates proposed for alternate interstate service. Even more recently, LDC's have entered into contracts with several EOR producers with transportation rates much lower than at previous levels.

There can be little question that all segments of the United States economy will benefit directly from the recent changes in California's natural gas regulatory structure which were prompted by the threat of direct head-to-head competition initiated by several interstate pipeline companies. The result of this competition will to be lower energy costs in developing crude oil production in California that would have otherwise been abandoned prematurely. Increased domestic oil production in the United States obviously will reduce import levels and in the longer-term will make American industry far more competitive on a worldwide basis.

In conclusion, Texaco reiterates that the Senate Bills will lock in short-sighted protectionist practices which will have the direct and unfortunate effect of undermining competition in the natural gas industry. America must be able to compete more effectively in the future, particularly in worldwide markets, and competition frankly means the ability of our industries to source the lowest cost energy which is available. In our view, there can be no compelling reason to protect LDC's since they are in the best position to compete effectively in maintaining current natural gas customers. The threat of competition will not harm consumers. It will force LDC's throughout the country to re-examine their rate and service policies in light of the demands of today's dynamic national and world economies. It will also aid in modernizing the ratemaking and regulatory schemes adopted by state regulatory agencies in establishing purchased gas and transportation rates for American industry. From an overall cost and benefit analysis, the United States has no choice but to allow competitive forces to work in the distribution of natural gas at the lowest levels which are available. The Senate Bills undoubtedly will have the effect of undermining these objectives.

Again, Texaco appreciates the opportunity to comment on S.1998 and S.2313.

DONELAN, CLEARY, WOOD & MASER, P. C.
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1275 K STREET, N. W
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October 4, 1988

Mr. Phil Jones
Legislative Assistant
Office of Hon. Daniel J. Evans
SH-324 Hart Senate Office Building
Washington, D.C. 20510-4702

Dear Phil:

Pursuant to our conversation September 28, 1988, I understand that Senator Evans will cause a copy of the September 22, 1988 letter from the Washington Utilities and Transportation Commission ("WUTC") to the Federal Energy Regulatory Commission to be entered into the record of the hearing held by the Committee on Energy and Natural Resources, Subcommittee on Energy Regulation and Conservation, on September 29, 1988.

While I quoted from the WUTC letter in my remarks to the Subcommittee, I did not expressly request that the letter be entered into the record, in light of your statement that Senator Evans would do so. For your convenience, a copy of the WUTC letter is attached hereto.

Very truly yours,

Ted P. Gerarden
Attorney for Cascade Natural Gas
Corporation

cc (w/ encl.): Joel Saltzman
Brian Matsuyama

Sharon L. Nelson, Charman
Richard D. Casad, Commissioner
A. J. "Bud" Pardini, Commissioner

STATE OF WASHINGTON
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION
1300 S. Evergreen Park Dr. S.W. • Olympia, Washington 98504-8002 • (206) 753-6423 • (SCAN) 234-6423

September 22, 1988

Honorable Martha O. Hesse
Chairman, Federal Energy Regulatory Commission
825 N. Capitol Street, NE
Washington, D.C. 20426

Re: Cascade Natural Gas Corporation v Northwest Pipeline Corporation, et al Docket No. CP88-286-000

Dear Chairman Hesse:

The Washington Utilities and Transportation Commission (WUTC) has followed with interest developments in the above-captioned case. The Complainant, Cascade Natural Gas Corporation (Cascade), has kept us advised of its filings in the matter and of the Federal Energy Regulatory Commission's (FERC) disposition of Cascade's Complaint on the basis of the Declaratory Order issued in Hadson Gas Systems, Inc., Docket No. GP88-11-000.

We are alarmed that FERC's decision in the Declaratory Order and on Cascade's Complaint appears to invite widespread bypass of local distribution company service. If the FERC order stands, it suggests that virtually any bypass of local distribution company service could be accomplished without review by either state authorities or the FERC. In the case of Northwest Pipeline Corporation's (Northwest) bypass of Cascade's service to Chevron Chemical Company (Chevron), because the bypass occurred under Sec. 311 of the Natural Gas Policy Act, Northwest has not applied to the WUTC for authorization to provide service displacing the service previously rendered by Cascade to Chevron. FERC's summary dismissal of Cascade's Complaint confirms that there will be no federal review of such self-implementing bypass on a case-by-case basis.

We have a particular concern that in its summary dismissal of the Cascade Complaint, FERC has introduced the prospect of widespread "double agency," where the pipeline transports gas for a shipper/producer (such as Grand Valley Gas Company) who is acting "on behalf of" an LDC. In this arrangement, the transportation contract is between the pipeline and the shipper/producer, and there is no link whatever between the pipeline and the LDC. The FERC itself acknowledged this problem in its discussion at the public meeting on July 12, 1988, where it was stated that there may be some confusion in the industry as to who has to be an agent for whom. We believe that FERC's failure to address this confusion, coupled with its interpretation of "in behalf of" extends the reach of Section 311 to precisely the transactions that seek to bypass.

If the FERC does continue to rely on the interpretation of Section 311 contained in Hadson and the Cascade decision, we believe that it should order a reduction of costs associated with the contract demand attached to the Chevron service provided by Cascade. During the FERC's discussion of the Cascade Complaint on July 13, Commissioner Stalon stated his view that "it is an indefensible practice to allow a bypass which deprives the LDC of a customer and then requires the LDC to continue to pay to the pipeline, and therefore incur a higher unit cost, and therefore make it more vulnerable to another bypass. Efficiency requires that the LDC be able to restructure its cost to meet its anticipated load..." (quoted in Request for Rehearing of Cascade Natural Gas, Aug. 18, 1988, p. 46).

Cascade procured 11,500 therms/day of firm gas to meet the needs of the Chevron Kenewick plant. Because of the FERC cost-allocation and rate structure, Cascade remains liable to Northwest for demand charges of approximately $69,000 annually for this supply. Northwest receives revenues for transporting the gas used to bypass Cascade while collecting demand charges from Cascade. The consequence of regulatory policy here is either to force Cascade to subsidize, through its demand payments, Northwest's ability to offer a competitive price to Cascade's former customer; or to enrich the pipeline unjustly.

As state regulators, we believe that widespread bypass under the interpretation of Section 311 embodied in the orders would not reflect economic efficiency but regulatory distortion. Cascade, like our other LDC's, has responded to the needs of large industrial customers by providing transportation of third-party gas; by purchasing supplies more economical than those offered by Northwest; and by discounting rates to those customers. In the context of Chairman Hesse's recent remarks to the effect that "many LDCs embrace transportation only after being threatened with bypass," it is important to point out that Cascade sought and received permission to transport gas to Chevron in October 1982. Yet Cascade's efforts are rendered meaningless if its pipeline supplier can use Section 311 to bypass.

FERC's refusal to consider whether the bypass of Cascade's service to Chevron is consistent with public convenience and necessity underscores the contradictory approach taken by the Commission. On the one hand, as FERC has stated in Hadson, open access transporation is intended to allow distributors an opportunity to compete by obtaining low cost gas supplies and offering to transport them to industrial customers. On the other hand, when Cascade has taken those steps; and continues to seek opportunities to lower costs to industrial customers, and is still bypassed, FERC refuses to examine the merits of Cascade's Complaint. To the extent that Hadson and the summary dismissal of the Complaint will further encourage pipelines to skim off industrial markets, leaving residential and small commercial customers to bear all of the fixed costs of a distribution system built largely to serve industrial customers, they are simply not sound public policy.

Because Northwest Pipeline continues to transport gas to the Chevron plant under Section 311 rather than under its blanket certificate, the issue is not moot; and FERC's decision on the Cascade Complaint would deprive that company of due process. For these reasons and the reasons above, we urge FERC to grant rehearing as requested by Cascade, and to order the Northwest-Chevron bypass transaction to cease until FERC can hold a hearing to determine whether bypass in this instance furthers public convenience and necessity, and is permissible under applicable Federal law. We also ask that if the Commission decides to deny the relief requested by Cascade and permit the bypass, the Commission authorize a corresponding reduction of cost associated with 11,500 therms/day in Cascade's firm entitlements from Northwest, effective March 1, 1988.

A copy of this letter is being sent to all parties to Docket No. CP88-286-000.

Respectfully submitted,

Sharon L Nelson

Sharon L. Nelson
Chairman

Richard D. Casad
Commissioner

A. J. Pardini
Commissioner

WOLVERINE
WORLD WIDE

WOLVERINE WORLD WIDE, INC. • ROCKFORD, MICHIGAN 49351 • 616-866-5500 • TWX 810-273-6160

September 26, 1988

The Honorable J. Bennett Johnston, Chairman
Committee on Energy and Natural Resources
Room SD-364 Dirkson Building
United States Senate
Washington, D.C. 20510

Mr. Chairman and Members of the Subcommittee, Wolverine World Wide, Inc. appreciates the opportunity to submit this statement in your hearing on S.2313, the "Natural Gas Transition Act" and S.1998, the "Natural Gas Consumers Protection Act."

Wolverine World Wide, Inc. is a company organized and existing under the laws of the State of Delaware with facilities located in the States of Michigan, Missouri, Arkansas, and New York. Our company manufactures and markets a wide variety of branded footwear and pigskin leather. Last year sales revenues were over 320 million dollars. Natural gas is a key component in our manufacturing process. Typically our company purchases over 200 MMCF of natural gas each year.

Our company supports legislation that:

(1) allows a willing buyer and seller of natural gas supplies to negotiate a fair price for such supplies;

(2) facilitates the transportation by the local gas distribution company of those supplies from the seller to the buyer without discrimination and at a transportation tariff established by the appropriate local or state regulatory commission;

(3) protects all gas customers - industrial, commercial, and residential - from the interstate pipeline market-raiding activities that benefit only a few large natural gas consumers at the expense of others;

(4) Prevents interstate pipelines from consolidating unfairly their monopoly positions to the detriment of producers and consumers of natural gas; and

(5) provides for the long-term viability of the natural gas market.

The two major objectives of Wolverine World Wide's energy policy are to meet our energy requirements at the lowest possible cost and to minimize the risks of a future energy supply shortage which could disrupt our operations. We recognize a degree of conflict in these objectives in that an extremely low price for energy supplies will likely result in a shortage. The challenge is to balance these two objectives.

Wolverine World Wide supports the free-market principles that allows an interested purchaser and seller to bargain freely. Likewise, our company favors the dismantlement of unnecessary and redundant regulation. We also recognize that sensible government regulations are needed at times in certain situations in order to foster worthy economic and social goals. This brings us to the subject of this hearing.

Over the past two to three years, with Federal Energy Regulatory Commission approval and encouragement, interstate pipelines have begun to aggressively seek out large industrial natural gas consumers served by state-regulated local distribution companies for direct sales, thus bypassing the latter. Bypass has been directed at large gas users and only at those large users that happen to be located close to an interstate pipeline. This is discrimination that meets neither the test of an unregulated market place nor the test of even handed regulations. When a large industrial user, served previously by the local distributor, is picked off by an interstate pipeline, then the remaining customers of the distributor must shoulder the fixed costs of the entire system. Fixed costs are shifted onto a small number of remaining customers, thus forcing prices upward which in turn leads to further losses. If unaddressed, customers who have no alternative sources of gas supplies will be seriously harmed.

Bypass has nothing to do with deregulation or with competition. It has everything to do with regulation. As you know, there is a long history and compelling reasons for the regulation of utilities, including protection of the customer and the utility investor. Since no one is proposing to deregulate either the pipelines or the local gas companies, this is not competition. Rather, the question is how are we going to regulate them.

The Federal Energy Regulatory Commission, under the theme of promoting competition, has abandoned its responsibility to regulate the pipelines. This is causing pipelines to construct wasteful and costly facilities that duplicate the same facilities built by local gas companies to serve identical customers. Building more facilities makes no sense at all unless your company happens to be a regulated utility that wants to expand its rate-base in order to increase earnings. Neither gas consumers nor gas producers received any benefits from the construction of duplicative facilities. Construction of duplicative facilities increases the fixed costs of the system without any increase in the volume of gas actually moved through the system.

This increases the cost of natural gas services to all consumers, including our company facilities which are least able to switch.

State regulatory authorities have different perspectives on the regulation of utility systems. State commissions are accustomed to using their authority to accomplish various social and revenue raising objectives. The Federal regulators may not agree with those objectives. Indeed, our company is not totally agreeable to the priorities of state regulators. The alternatives of depending on Federal regulators in local matters or allowing the pipeline unchecked is unacceptable.

Wolverine World Wide urges this Subcommittee to approve legislation to prohibit the interstate pipelines from bypassing local gas distribution but only if the latter is willing to transport gas without discrimination on the basis of the source, ownership, or destimation of the gas and is willing to transport gas at the cost of providing that service. In other words, we are not asking that local utilities and state regulators be protected from competition while they engage in monopoly or regulatory abuse.

Thank you,

Harlan L. Schram
Corporate Energy Coordinator

HLS/pl

September 27, 1988

Honorable Howard M. Metzenbaum
Senate Energy and Natural
  Resources Committee
140 Russell Senate Office Building
Washington, D. C. 20510-3502

Dear Senator Metzenbaum:

We understand a hearing is scheduled on September 29, 1988 before the Subcommittee on Energy Regulation and Conservation on S. 2313 and S. 1998, bills pertaining to alternative sourcing of natural gas by industrial users. Some of us will be participating in this hearing to register our strong objection to these anti-competitive bills.

These bills disrupt and reverse existing law embodied in the Natural Gas Act. They represent a gross overreaction to one decision by the Federal Energy Regulatory Commission (FERC) approving a contested case in Michigan involving an interstate pipeline's direct service to a local distribution company (LDC) served user.

During the last few days of the 100th Congress, insufficient time exists to carefully consider such extremely controversial legislation and we strongly urge that, even if this hearing must go forward, there be no further action on these highly objectionable bills.

Sincerely,

American Iron and Steel Institute
Aluminum Association
American Paper Institute
Chemical Manufacturers Association
Council of Industrial Boiler Owners
The Fertilizer Institute
Independent Petroleum Association of America
Interstate Natural Gas Association of America
Motor Vehicle Manufacturers Association of the United States
National Association of Manufacturers
National Council of Farmer Cooperatives
Natural Gas Supply Association
Northwest Industrial Gas Users
Petrochemical Energy Group
Process Gas Consumers Group